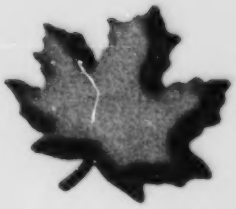


# Tax Expenditures and Evaluations

## 2000

Department of Finance Canada
Ministère des Finances Canada

© **Her Majesty the Queen in Right of Canada (2000)**
**All rights reserved**

All requests for permission to reproduce this document or any part thereof shall be addressed to Public Works and Government Services Canada.

Available from the

Distribution Centre
Department of Finance Canada
Room P-135, West Tower
300 Laurier Avenue West
Ottawa, Ontario K1A 0G5
Tel: (613) 943-8665
Fax: (613) 996-0901

**Price: $16.00 (including GST)**
(This price includes *Tax Expenditures: Notes to the Estimates/Projections*)

This document is available free on the Internet at
http://www.fin.gc.ca/

*Cette publication est également disponible en français.*

Cat No.: **F1-27/2000E**
**ISBN 0-660-18242-4**

# TABLE OF CONTENTS

Preface ..... 5

**Part 1 – Tax Expenditures: Estimates and Projections** ..... 7

Estimates and Projections of Tax Expenditures ..... 9

What's New in the 2000 Report? ..... 10

The Tax Expenditures ..... 14
Table 1: Personal Income Tax Expenditures ..... 15
Table 2: Corporate Income Tax Expenditures ..... 26
Table 3: GST/HST Tax Expenditures ..... 32

**Part 2 – Tax Evaluations and Research Reports** ..... 35

Defining Tax Expenditures ..... 37

The Alternative Minimum Tax ..... 57

GST/HST Treatment of Export Distribution ..... 85

## PREFACE

Starting with this issue, *Tax Expenditures* will be published as two separate documents: *Tax Expenditures and Evaluations* and *Tax Expenditures: Notes to the Estimates/Projections*.

*Tax Expenditures and Evaluations*, which will be published annually, will continue to provide estimates and projections for broadly defined tax expenditures. In addition, starting this year, this report will include descriptive papers on tax expenditures that readers may find useful. This year's report contains the following three papers:

- "Defining Tax Expenditures." In light of developments in this area over the past decade and in light of the diverse practices followed by different countries in reporting tax expenditures, this paper reviews various methodologies for identifying and reporting tax expenditures.
- "The Alternative Minimum Tax." This paper reviews the alternative minimum tax (AMT) and demonstrates that the Canadian AMT has achieved its objective of reducing the extent to which high-income tax filers pay little or no income tax.
- "GST/HST Treatment of Export Distribution." This paper provides further background information on measures in this area introduced in the 2000 budget.

The second document, *Tax Expenditures: Notes to the Estimates/Projections*, sets out the approach used in developing the estimates and projections for the tax expenditures contained in the first report. It also provides a description of each tax expenditure and a statement of their objectives. Until now, this information was published in the same report as the estimates and projections; the move to separate documents will therefore make the main report easier to use. This second report will be published less frequently than the main report given that the information it contains does not change often.

# Part 1

## TAX EXPENDITURES: ESTIMATES AND PROJECTIONS

## ESTIMATES AND PROJECTIONS OF TAX EXPENDITURES

While there is agreement on the conceptual definition of tax expenditures, there is no widely accepted operational methodology for estimating them. A range of methodologies exists internationally, some restrictive, others very broad. The broadest of the available options is to estimate tax expenditures as all deviations from a benchmark tax system. Typically, these deviations take the form of exemptions, deductions, rate reductions, rebates, credits, deferrals and carry-overs.

The approach used in this document seeks to provide as much information as possible to the reader, without getting into a controversy as to whether or not an item is a tax expenditure. Consequently, any deviation from a narrowly defined tax structure is reported. This allows the reader to decide whether or not a particular item qualifies as a tax expenditure. These deviations from the tax system are reported in two parts: one includes a list of all items that could be considered tax expenditures under a very broad (and perhaps unrealistic) definition; all other deviations from the benchmark tax system are reported as memorandum items.

### Caveats

Care must be taken in interpreting the estimates and projections of tax expenditures in the tables for the following reasons.

- Tax expenditures are values of tax revenues forgone to achieve a variety of economic and social objectives. Whether or not the magnitudes of tax expenditures are appropriate depends upon an evaluation of the social and economic policies that generated them. The values reported in the tables provide no information to permit such an evaluation.
- Estimates of various tax expenditure items cannot be added together – this is because the cost of each tax expenditure is estimated separately, assuming that all other tax provisions remain unchanged.
- The estimates assume all other factors remain unchanged (i.e., there is no allowance for behavioural changes, consequential government policy changes or changes in aggregate economic activity in response to the change in the tax expenditure).
- In addition to these considerations, the projections are subject to forecast error and are "best efforts" that have no greater degree of reliability than the variables that explain them.
- The federal and provincial income tax systems interact with each other to various degrees. As a result, changes to tax expenditures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account – that is, the tax expenditure estimates are purely federal in nature.
- In the case of the harmonized sales tax in effect in Nova Scotia, New Brunswick, and Newfoundland and Labrador, only the federal cost of the tax expenditures is reported.

It should also be noted that, on occasion, the estimated or projected change in the value of a tax expenditure in this report does not coincide with that shown in the 2000 budget. For example, this report shows that the cost of the capital gains inclusion rate increased by $450 million between 1999 and 2000. This increase is due to the reduction in the inclusion rate from three-quarters to two-thirds that was announced in the 2000 budget. However, according to the 2000 budget estimate, the cost of this change is only $135 million for that same period. By itself, the reduction in the capital gains inclusion rate raises tax expenditures and lowers budgetary revenues by the same amount. But the lower inclusion rate is expected to induce additional realizations, which reinforces the increase in tax expenditures while providing an offset to the loss in budgetary revenues. As a result, a substantial gap between the two estimates emerges.

A second example is the change in the partial exemption of scholarship, fellowship and bursary income, which was also announced in the 2000 budget. The cost of this change was estimated at $30 million for the 2000 tax year. In contrast, the associated tax expenditure provided in this document is $16 million in 2000 (up $13 million from $3 million in 1999). In this case, the apparent disparity is largely a matter of presentation. The total cost of this measure shown in the budget is spread over two or more categories in this report. The 2000 budget estimate of $30 million consists of $13 million that will be claimed by students and a further $17 million that will either be carried forward or transferred to parents and claimed by them. These amounts are shown separately in this report.

## WHAT'S NEW IN THE 2000 REPORT?

The 2000 budget made changes that affect the value of a large number of tax expenditures. The benchmark against which tax expenditures are measured was altered by reducing the middle tax rate and reintroducing full indexation in the personal income tax system, and by reducing the general corporate tax rate. This has an indirect effect on the value of personal and corporate tax expenditures. For example, the tax expenditures associated with the low rate for small business and for manufacturing and processing are reduced because they are measured against a lower benchmark. In addition, changes were made to specific tax expenditures, and this affects their value directly.

These changes are noted below.

## *Personal Income Tax*

### Eliminate Automatic Increases in the Tax Burden Due to Inflation

- Immediately restore full indexation of the tax system effective January 1, 2000, for all amounts that were previously partially indexed, the income thresholds affecting these amounts, and the taxable income thresholds at which all marginal tax rates begin to apply. The indexation factor for a given taxation year beginning January 1 is the percentage change in the average consumer price index for the 12-month period ending on September 30 of the previous year.

- Indexation will increase tax expenditures associated with indexed credits, such as the spousal credit, by increasing their value, and with credits with indexed thresholds, such as the Canada Child Tax Benefit, by increasing the number of eligible claimants.
- On the other hand, by eliminating bracket creep, indexation will reduce the tax expenditures associated with non-refundable credits, such as the tuition credit, used by low-income earners to reduce their federal taxes owing to zero.

## Reduce the High Tax Burden at the Middle-Income Level

- Reduce the middle income tax rate from 26 per cent to 24 per cent effective July 1, 2000.
- Increase the 5-per-cent surtax threshold from $12,500 to $18,500 of basic federal tax (at an income level of about $85,000) effective July 1, 2000, and reduce the surtax rate from 5 per cent to 4 per cent effective January 1, 2001.
- These measures will generally reduce tax expenditures associated with certain deductions and non-taxable benefits, such as business-paid health and dental benefits, by reducing marginal tax rates.

## Increase Support for Children

- Increase the Canada Child Tax Benefit base benefit by $70 per child, including indexation, effective July 2000.
- By July 2001, increase the National Child Benefit supplement by $200 per child, including indexation, from the currently scheduled July 2000 levels of $955 for the first child, $755 for the second child and $680 for each subsequent child.

## Make the Income Tax System More Internationally Competitive

- Reduce the capital gains inclusion rate from three-quarters to two-thirds for capital gains realized after February 27, 2000.
- Postpone taxation of gains on shares acquired under qualifying stock options to when shares are sold rather than when options are exercised.
- Allow tax-free rollover of capital gains on qualified investments from one small business to another.
- Increase the limit for the foreign property rule in respect of deferred income plans generally to 25 per cent for 2000 and 30 per cent after 2000, from the prior level of 20 per cent. The limit had been raised from 10 per cent between 1990 and 1994.
- Increase the annual exemption on scholarship, fellowship and bursary income from $500 to $3,000 beginning with the 2000 taxation year. The increase applies only to amounts received by students enrolled in programs that entitle them to claim the education credit.

## Enhance Tax Assistance for Charities

- Eliminate the $1,000 minimum deemed adjusted cost base and deemed proceeds of disposition when personal-use property is donated as a charitable gift, if the personal-use property is acquired after February 27, 2000.
- Extend the charitable donations tax credit to donations of registered retirement savings plan, registered retirement income fund and insurance proceeds that are made as a consequence of direct beneficiary designations. This measure will apply in respect of an individual's death that occurs after 1998.
- Further enhance the incentives for the protection of ecologically sensitive lands by reducing the income inclusion rate by one-half in respect of capital gains arising from gifts of ecologically sensitive land and related easements, covenants and servitudes to qualified donees other than private foundations.
- Reduce by half the income inclusion of stock option employment benefits realized as a result of the charitable donations of shares acquired with employee stock options. This will allow the tax treatment of such donations to parallel the reduced capital gains inclusion rate for donations of publicly traded securities.

## Enhance Tax Assistance for Persons With Disabilities

- Extend eligibility for the disability tax credit (DTC) to individuals requiring extensive therapy.
- Expand the list of relatives to whom the DTC can be transferred.
- Increase the value of the DTC by up to $500 for families caring for children eligible for the DTC.
- Increase the maximum child care expense deduction available in respect of persons eligible for the DTC to $10,000 from $7,000.
- Make expenses relating to the costs of adapting a new home to the needs of a disabled person eligible under the medical expense tax credit.
- Expand the attendant care deduction to include the cost of an attendant required in order to attend school.

## Other

- Reduce the special federal surtax levied on individuals who have income that is considered to have been earned in Canada, but which is not considered to have been earned in a province. In light of recent changes in provincial tax rates, the federal surtax on income not earned in a province will be reduced from 52 per cent of basic federal tax to 48 per cent.
- Offset interest on personal tax overpayments and underpayments to ensure that refund interest accruing over a period is taxed only to the extent that it exceeds any arrears interest that accrued over the same period to which the refund interest relates.

## Business Income Tax

- Reduce the federal corporate income tax rate on business income not eligible for special tax treatment by 1 percentage point from 28 to 27 per cent, effective January 1, 2001. This lower rate will not apply to small business and Canadian manufacturing and processing income, investment income that benefits from refundable tax provisions or income from non-renewable natural resource activities. The reduction will also not apply to mutual fund corporations, mortgage investment corporations and investment corporations. As such, the corporate tax rate used for the benchmark, including the corporate surtax, is reduced to 28.12 per cent for 2001 and 2002, from 29.12 per cent in previous years.
- Reduce the federal corporate income tax rate on income between $200,000 and $300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada by 7 percentage points from 28 to 21 per cent, effective January 1, 2001. Income eligible for this lower rate will be reduced to the extent that the corporation has manufacturing and processing (M&P) income subject to the reduced M&P tax rate or income from resource activities.
- Extend the temporary capital tax surcharge on large deposit-taking institutions to October 31, 2001, pending completion of a review of the application of the surcharge. This review was announced in June 1999 as part of the reform of the financial services sector.

## Sales Tax

- Introduce a new partial rebate for the goods and services tax/harmonized sales tax (GST/HST) paid on newly constructed or substantially renovated residential rental property.

## THE TAX EXPENDITURES

Both the estimates and the projected values of the tax expenditures associated with the GST/HST have been substantially revised. These result from the use of more recent (1996) and more detailed data that have become available from Statistics Canada. This improved data has allowed us to prepare more accurate estimates and projections of these tax expenditures. This increased accuracy is due to improved data on the overall level of total expenditures on goods and services and on the proportion of that spending that is non-taxable.

Other minor changes have been made to provide information that was not previously available and to update or otherwise improve the estimates and projections for certain measures. For example, more detailed estimates and projections are provided relating to refundable taxes on investment income of private corporations. In previous years, this measure reflected only the portion of corporate taxes collected that were refundable. This report now provides details of the additional refundable taxes collected, the amount refunded and the net expenditure.

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the GST/HST for the years 1995 to 2002. In the case of personal income tax, tax expenditures are grouped according to functional categories. This grouping is provided solely for organizational purposes. It is not intended as a policy justification for the specific provisions and all tax measures do not fall neatly into one of the categories.

All estimates are reported in millions of dollars. The letter "S" indicates that the cost is less than $2.5 million, "n.a." signifies that data were not available and a dash means that the tax expenditure was not in effect. The inclusion in the report of items for which estimates are not available is warranted given that the report is designed to provide information on the type of assistance delivered through the tax system even if it is not always possible to provide a quantitative estimate. Work is continuing to obtain quantitative estimates where possible. For example, the personal income tax expenditure associated with the reclassification of flow-through shares is a new item this year.

Table 1

**Personal income tax expenditures**[*] [†]

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Culture and Recreation** | | | | | | | | |
| Deduction for clergy residence | 56 | 58 | 58 | 60 | 60 | 60 | 60 | 60 |
| Flow-through of capital cost allowance (CCA) on Canadian films[1] | 48 | – | – | – | – | – | – | – |
| Deduction for certain contributions by individuals who have taken vows of perpetual poverty | S | S | S | S | S | S | S | S |
| Write-off of Canadian art purchased by unincorporated businesses | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Assistance for artists | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deduction for artists and musicians | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of capital gains on gifts of cultural property | n.a. | n.a. | 7 | 7 | 7 | 7 | 7 | 7 |
| **Education** | | | | | | | | |
| Tuition fee credit[2] | 195 | 210 | 225 | 205 | 200 | 195 | 200 | 210 |
| Education credit[3] | 44 | 55 | 64 | 76 | 72 | 68 | 69 | 71 |
| Education and tuition fee credits transferred[4] | 215 | 260 | 375 | 425 | 435 | 435 | 450 | 460 |
| Carry-forward of education and tuition fee credits[5] | – | – | – | 30 | 30 | 115 | 130 | 140 |
| Student loan interest credit[6] | – | – | – | 120 | 135 | 150 | 160 | 175 |
| Registered education savings plans (RESPs)[7] | n.a. | 35 | 32 | 43 | 80 | 135 | 210 | 290 |
| Partial exemption of scholarship, fellowship and bursary income[8] | 6 | 6 | 4 | 3 | 3 | 16 | 16 | 16 |
| Deduction of teachers' exchange fund contributions | S | S | S | S | S | S | S | S |

[*] **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the companion document, *Tax Expenditures: Notes to the Estimates/Projections*, for a discussion of the reasons for this.**

[†] The 2000 budget proposed to restore full indexation to the personal income tax system effective January 1, 2000. This eliminates the provision put in place in 1986 that applied indexation to the personal income tax system only for inflation above 3 per cent. Parameters affected include the basic personal credit and the level of income at which the middle and top tax rates begin to apply. The 2000 budget also proposed to reduce the middle tax rate to 24 per cent from 26 per cent effective July 1, 2000. These measures, which will reduce average tax rates in the 2000 tax year and again in 2001, explain some of the changes in tax expenditures from 1999 to 2000, and again from 2000 to 2001.

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Employment** | | | | | | | | |
| Deduction of home relocation loans | S | S | S | S | S | S | S | S |
| Non-taxation of allowances for volunteer firefighters[9] | 4 | 4 | 4 | – | – | – | – | – |
| Tax-free amount for emergency service volunteers[9] | – | – | – | 14 | 14 | 14 | 14 | 14 |
| Northern residents deductions | 125 | 125 | 130 | 130 | 130 | 130 | 125 | 125 |
| Overseas employment credit | 31 | 44 | 37 | 38 | 39 | 39 | 39 | 39 |
| Employee stock options[10] | 74 | 125 | 200 | 205 | 210 | 280 | 285 | 285 |
| Non-taxation of strike pay | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deferral of salary through leave of absence/sabbatical plans | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Employee benefit plans | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of certain non-monetary employment benefits | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Family** | | | | | | | | |
| Spousal credit[11, 12] | 1,200 | 1,205 | 1,150 | 1,150 | 1,250 | 1,375 | 1,435 | 1,485 |
| Equivalent-to-spouse credit[11, 12] | 470 | 470 | 425 | 415 | 440 | 475 | 490 | 500 |
| Infirm dependant credit[12, 13] | 6 | 7 | 7 | 7 | 7 | 7 | 7 | 7 |
| Caregiver credit[12, 14] | – | – | – | 30 | 45 | 60 | 70 | 75 |
| Canada Child Tax Benefit (CCTB)[12, 15] | 5,240 | 5,235 | 5,325 | 5,625 | 5,995 | 6,930 | 7,820 | 8,160 |
| Deferral of capital gains through transfers to a spouse, spousal trust or family trust | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Farming and Fishing** | | | | | | | | |
| $500,000 lifetime capital gains exemption for farm property[16] | 275 | 325 | 355 | 365 | 365 | 325 | 325 | 330 |
| Net Income Stabilization Account | | | | | | | | |
| Deferral of tax on government contributions[17] | 31 | 115 | 89 | 80 | 100 | 87 | 87 | 87 |
| Deferral of tax on bonus and interest income | 14 | 19 | 21 | 32 | 38 | 43 | 48 | 53 |
| Taxable withdrawals[17] | -15 | -35 | -35 | -63 | -105 | -67 | -67 | -67 |
| Deferral of income from destruction of livestock | S | S | S | S | S | S | S | S |
| Deferral of income from grain sold through cash purchase tickets[17, 18] | 19 | 6 | -1 | -32 | -9 | -9 | -9 | -9 |
| Deferral through 10-year capital gain reserve[17] | 8 | -2 | 9 | 5 | 5 | 5 | 5 | 5 |
| Deferral of capital gains through intergenerational rollovers of family farms | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a |
| Exemption from making quarterly tax instalments | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a |
| Cash basis accounting | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a |
| Flexibility in inventory accounting | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a |
| **Federal-Provincial Financing Arrangements** | | | | | | | | |
| Quebec abatement | 2,320 | 2,410 | 2,560 | 2,730 | 2,840 | 2,925 | 3,025 | 3,155 |
| Transfers of income tax room to provinces | 9,745 | 10,240 | 11,215 | 12,105 | 12,630 | 12,995 | 13,455 | 14,060 |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **General Business and Investment** | | | | | | | | |
| $100,000 lifetime capital gains exemption[19] | 34 | – | – | – | – | – | – | – |
| Partial inclusion of capital gains[20] | 405 | 655 | 920 | 930 | 940 | 1,390 | 1,370 | 1,355 |
| Deduction of limited partnership losses | 195 | 205 | 185 | 200 | 215 | 225 | 235 | 240 |
| Investment tax credits | 54 | 39 | 25 | 25 | 26 | 26 | 27 | 27 |
| Deferral through five-year capital gain reserve[17] | -6 | 12 | 17 | 8 | 8 | 8 | 8 | 8 |
| Deferral through capital gains rollovers[21] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deferral through use of billed-basis accounting by professionals | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deduction of accelerated tax depreciation[22] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| $1,000 capital gains exemption on personal-use property[23] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| $200 capital gains exemption on foreign exchange transactions | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Taxation of capital gains upon realization | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Health** | | | | | | | | |
| Non-taxation of business-paid health and dental benefits[24] | 1,440 | 1,490 | 1,625 | 1,755 | 1,760 | 1,720 | 1,685 | 1,675 |
| Disability tax credit (DTC)[12, 25] | 270 | 265 | 270 | 270 | 275 | 310 | 310 | 310 |
| Medical expense tax credit[12, 26] | 305 | 330 | 350 | 355 | 375 | 395 | 430 | 465 |
| Medical expense supplement for earners[12, 27] | – | – | 29 | 30 | 33 | 37 | 39 | 41 |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Income Maintenance and Retirement** | | | | | | | | |
| Non-taxation of Guaranteed Income Supplement and spouse's allowance benefits | 285 | 300 | 290 | 280 | 265 | 255 | 270 | 280 |
| Non-taxation of social assistance benefits[28] | 635 | 560 | 450 | 415 | 375 | 345 | 335 | 325 |
| Non-taxation of workers' compensation benefits | 635 | 620 | 630 | 650 | 650 | 650 | 650 | 650 |
| Non-taxation of certain amounts received as damages in respect of personal injury or death | 19 | 18 | 18 | 18 | 18 | 18 | 18 | 18 |
| Non-taxation of veterans' allowances, civilian war pensions and allowances, and other service pensions (including those from Allied countries)[29] | 4 | 4 | S | S | S | S | S | S |
| Non-taxation of veterans' disability pensions and support for dependants[29] | 135 | 140 | 155 | 160 | 155 | 150 | 150 | 150 |
| Treatment of alimony and maintenance payments[30] | 250 | 250 | 240 | 245 | 250 | 245 | 245 | 245 |
| Age credit[12] | 1,270 | 1,320 | 1,350 | 1,320 | 1,285 | 1,285 | 1,330 | 1,360 |
| Pension income credit | 350 | 365 | 385 | 390 | 390 | 395 | 405 | 410 |
| Saskatchewan Pension Plan | S | S | S | S | S | S | S | S |
| Registered retirement savings plans | | | | | | | | |
| Deduction for contributions | 5,290 | 5,940 | 6,385 | 6,420 | 6,935 | 7,315 | 7,675 | 8,290 |
| Non-taxation of investment income[31] | 3,850 | 3,520 | 3,190 | 3,175 | 3,655 | 4,465 | 4,680 | 5,200 |
| Taxation of withdrawals | -1,750 | -2,190 | -2,425 | -2,610 | -2,830 | -3,015 | -3,210 | -3,515 |
| Net expenditure[32] | 7,390 | 7,270 | 7,150 | 6,985 | 7,760 | 8,765 | 9,145 | 9,975 |
| Registered pension plans | | | | | | | | |
| Deduction for contributions | 4,925 | 4,930 | 4,930 | 5,275 | 5,310 | 5,220 | 5,090 | 5,160 |
| Non-taxation of investment income[31] | 10,040 | 9,020 | 8,630 | 8,310 | 8,850 | 9,985 | 9,605 | 9,865 |
| Taxation of withdrawals | -4,520 | -4,905 | -5,370 | -6,630 | -7,290 | -7,900 | -8,555 | -9,460 |
| Net expenditure[32] | 10,445 | 9,045 | 8,190 | 6,955 | 6,870 | 7,305 | 6,140 | 5,565 |
| Deferred profit-sharing plans | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| Non-taxation of RCMP pensions/compensation in respect of injury, disability or death[33] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of up to $10,000 of death benefits | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of investment income on life insurance policies[34] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Small Business** | | | | | | | | |
| $500,000 lifetime capital gains exemption for small business shares[16, 35] | 590 | 475 | 545 | 560 | 565 | 485 | 490 | 495 |
| Deduction of allowable business investment losses | 79 | 74 | 55 | 57 | 59 | 60 | 61 | 62 |
| Labour-sponsored venture capital corporations credit[36, 37] | 235 | 91 | 79 | 130 | 180 | 180 | 180 | 180 |
| Deferral through 10-year capital gain reserve[17] | -2 | -5 | 13 | 2 | 2 | 2 | 2 | 2 |
| Rollovers of investments in small businesses[38] | – | – | – | – | – | 75 | 75 | 75 |
| **Other Items** | | | | | | | | |
| Non-taxation of capital gains on principal residences[16, 39] | | | | | | | | |
| Partial inclusion rate | 1,085 | 1,260 | 1,310 | 940 | 1,170 | 1,025 | 980 | 970 |
| Full inclusion rate | 1,435 | 1,680 | 1,745 | 1,250 | 1,555 | 1,505 | 1,470 | 1,455 |
| Non-taxation of income from the Office of the Governor General | S | S | S | S | S | S | S | S |
| Assistance for prospectors and grubstakers | S | S | S | S | S | S | S | S |
| Charitable donations credit[40] | 975 | 1,120 | 1,180 | 1,350 | 1,360 | 1,365 | 1,395 | 1,415 |
| Reduced inclusion rate for capital gains arising from donations of ecologically sensitive land[41] | – | – | – | – | – | n.a. | n.a. | n.a. |
| Reduced inclusion rate for capital gains arising from certain charitable donations[42] | – | – | 6 | 6 | 10 | 20 | 35 | – |
| Political contribution tax credit | 10 | 11 | 16 | 16 | 17 | 17 | 18 | 18 |
| Special tax computation for certain retroactive lump-sum payments[43] | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 |
| Non-taxation of income of Indians on reserves | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of gifts and bequests | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Memorandum Items** | | | | | | | | |
| Non-taxation of lottery and gambling winnings[44] | 1,155 | 1,380 | 1,340 | 1,515 | 1,575 | 1,635 | 1,675 | 1,760 |
| Non-taxation of specified incidental expenses | 6 | 5 | 4 | 4 | 4 | 4 | 4 | 4 |
| Non-taxation of allowances for diplomats and other government employees posted abroad | 9 | 8 | 8 | 8 | 8 | 8 | 8 | 8 |
| Child care expense deduction[45] | 365 | 420 | 480 | 515 | 520 | 515 | 500 | 495 |
| Attendant care expense deduction | S | S | S | S | S | S | S | S |
| Moving expense deduction[46] | 61 | 64 | 59 | 60 | 61 | 62 | 62 | 62 |
| Deduction of carrying charges incurred to earn income[17] | 645 | 590 | 575 | 600 | 590 | 590 | 590 | 590 |
| Deduction of meals and entertainment expenses | 97 | 130 | 71 | 74 | 75 | 75 | 75 | 75 |
| Deduction of farm losses for part-time farmers[47] | 56 | 57 | 57 | 57 | 58 | 58 | 58 | 58 |
| Farm and fishing loss carry-overs | 10 | 10 | 9 | 9 | 9 | 9 | 9 | 9 |
| Capital loss carry-overs | 89 | 160 | 180 | 185 | 185 | 185 | 185 | 185 |
| Non-capital loss carry-overs | 86 | 100 | 86 | 89 | 90 | 90 | 91 | 92 |
| Logging tax credit | S | S | S | S | S | S | S | S |
| Deduction of resource-related expenditures | 78 | 170 | 175 | 180 | 185 | 185 | 190 | 190 |
| Reclassification of flow-through shares[17, 48] | n.a. | 38 | 42 | 21 | 34 | 34 | 34 | 34 |
| Deduction of other employment expenses | 540 | 585 | 610 | 630 | 645 | 650 | 655 | 670 |
| Deduction of union and professional dues | 505 | 510 | 510 | 530 | 545 | 555 | 560 | 565 |
| Employment insurance | | | | | | | | |
| Employment insurance contribution credit | 1,320 | 1,260 | 1,400 | 1,330 | 1,275 | 1,210 | 1,245 | 1,275 |
| Non-taxation of employer-paid premiums | 2,715 | 2,610 | 2,935 | 2,845 | 2,760 | 2,580 | 2,600 | 2,640 |
| Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) | | | | | | | | |
| CPP and QPP contribution credit | 1,135 | 1,195 | 1,310 | 1,460 | 1,645 | 1,865 | 2,140 | 2,410 |
| Non-taxation of employer-paid premiums | 1,470 | 1,550 | 1,695 | 1,915 | 2,170 | 2,410 | 2,715 | 3,030 |
| Foreign tax credit[49] | 280 | 300 | 335 | 345 | 350 | 355 | 365 | 370 |
| Dividend gross-up and credit | 730 | 815 | 895 | 965 | 1,035 | 1,110 | 1,215 | 1,320 |

Table 1
**Personal income tax expenditures** *(cont'd)*

| | Estimates | | | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | | ($ millions) | | | | |
| Supplementary low-income credit[50] | – | – | – | 140 | 150 | – | – | – |
| Basic personal credit[12, 51] | 17,650 | 17,885 | 18,250 | 18,145 | 19,145 | 20,445 | 21,180 | 21,810 |
| Non-taxation of capital dividends | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

***Notes:***

[1] The flow-through of CCA on Canadian films is not available for taxation years later than 1995 – it was replaced by a tax credit for producers.

[2] The 1997 budget extended this credit to most mandatory ancillary fees imposed by post-secondary institutions, beginning in 1997.

[3] The 1996 budget increased this credit from $80 to $100 per month, beginning in 1996. The 1997 budget increased this credit to $150 per month for 1997 and $200 per month thereafter. The 1998 budget allowed part-time students to claim a part-time education amount of $60 per month.

[4] The 1996 budget increased from $4,000 to $5,000 the limit on the transfer of these amounts, beginning in 1996. The increase in this tax expenditure in 1997 reflects a 50-per-cent increase in the average claim in that year.

[5] The 1997 budget introduced this measure, effective for 1997 and subsequent years.

[6] This measure was introduced in the 1998 budget.

[7] In the 1998 budget, the Government announced that it would supplement annual contributions to RESPs with a 20-per-cent grant, the Canada Education Savings Grant, beginning in 1998. While this enhancement does not represent a tax expenditure, it increases the cost of the tax expenditure to the extent that it encourages participation in the RESP program. No information is available for years prior to 1996.

[8] The 2000 budget proposed to raise the exemption for scholarship, fellowship and bursary income from $500 to $3,000 for students eligible for the education credit. In addition, for 2000 and later tax years, the tax expenditure reflects the additional funds made available to students under the Canada Millennium Scholarships.

[9] The 1998 budget replaced the $500 tax-free allowance for volunteer firefighters with an exemption of up to $1,000 for emergency service volunteers. The tax expenditure estimate for the emergency service volunteer exemption includes claims by firefighters after 1997.

[10] This tax expenditure reflects only the stock option deduction and not the deferral from income inclusion. The increase in this tax expenditure in 1996 reflects a 30-per-cent increase in the number of claimants and a 30-per-cent increase in the average claim in that year. The increase in this tax expenditure in 1997 reflects a 65-per-cent increase in the number of claimants. The 2000 budget proposed to increase the stock option deduction from one-quarter to one-third.

[11] The 1999 budget increased this tax credit by $675 for all taxpayers, beginning July 1, 1999.

[12] The 2000 budget proposed to fully index this tax credit effective January 1, 2000. The 2000 budget also proposed to fully index the income levels at which the middle and top tax rates begin to apply. These proposals represent a change in the benchmark tax system, and consequently, there is no tax expenditure associated with indexation.

[13] The 1996 budget increased the maximum credit per dependant from $270 to $400.

[14] This credit, introduced in the 1998 budget, is projected to be significantly lower than previously reported in the absence of actual taxpayer data. Last year's publication projected this tax expenditure to be $120 million for 1998. Based on preliminary tax data, this tax expenditure is now projected to be $30 million for 1998. The lower figure indicates a much smaller number of filers claiming a dependent relationship than had been previously anticipated.

[15] The 1996 through 2000 budgets increased this tax benefit. Payments made between January and December of the year are reported. The 2000 budget proposed additional enrichments to the CCTB. It also proposed that the CCTB be fully indexed starting January 2000. Increases in amounts over and above indexation are scheduled for the CCTB base benefit in July 2000 and for the National Child Benefit supplement in July 2001.

[16] The decline in this tax expenditure after 1999 reflects in part the proposal in the 2000 budget to reduce the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000.

[17] This tax expenditure is highly volatile. It is projected at its historical average.

[18] Data upon which this tax expenditure is estimated was available up to 1998.

[19] The lifetime capital gains exemption for general property was eliminated after 1994. However, the tax expenditure for 1995 reflects late and adjusted elections filed in that year with respect to gains accrued up to February 22, 1994.

[20] The increase in the value of this tax expenditure for 1997 reflects a 45-per-cent increase in the amount of taxable capital gains reported in that year. Projections are based on historical trends. The 2000 budget proposed to reduce the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000.

[21] This tax expenditure does not include the 2000 budget proposal for rollovers of eligible small business investments.

[22] This tax expenditure includes the deduction of scientific research and experimental development expenditures. Data are not available to estimate this tax expenditure with precision.

[23] The 2000 budget proposed to amend the rules so that the $1,000 deemed adjusted cost base and deemed proceeds of disposition for personal-use property will not apply if the property is acquired after February 27, 2000, as part of an arrangement in which the property is donated as a charitable gift.

[24] The 1998 budget allowed unincorporated owner-operators to deduct premiums for supplementary health care coverage against their business income to a maximum amount, beginning in 1998.

[25] The 2000 budget proposed to enhance the DTC by extending eligibility to individuals requiring extensive therapy, and to expand the list of relatives to whom the DTC can be transferred. The 2000 budget also proposed a supplement of up to $500 for children eligible for the DTC.

[26] The 1997 budget broadened this credit to cover additional expenses, beginning in 1997. The 1999 budget further broadened this credit for the care and education of persons with disabilities, beginning in 1999.

[27] This measure was introduced in the 1997 budget.

[28] The projected decline in this tax expenditure after 1997 reflects changes in the 1998, 1999 and 2000 budgets to reduce tax rates on low-income individuals (e.g., the increase in the personal amounts in the 1998 and 1999 budgets).

[29] Public Accounts data used for this tax expenditure was available up to 1998.

[30] The 1996 budget eliminated the income inclusion for recipients of child support payments, and disallowed the deduction for payers, for agreements made after April 30, 1997.

[31] Projected values for this tax expenditure are lower than those provided in last year's publication due to lower-than-expected interest rates in those years.

[32] Net expenditure represents the total tax expenditure associated with this measure.

[33] The amounts reported in previous years for this tax expenditure included taxable amounts and did not cover all non-taxable RCMP pensions. This tax expenditure cannot be estimated with precision.

[34] Although this measure does provide tax relief for individuals, it is implemented through the corporate tax system. See under "Interest credited to life insurance policies" in the corporate income tax expenditure tables for an estimate of the value of this tax expenditure.

[35] The increase in this tax expenditure in 1997 reflects a 65-per-cent increase in the number of claims and a 10-per-cent increase in the average claim in that year.

[36] The 1996 budget reduced this credit from 20 per cent to 15 per cent and the purchase amount eligible for the credit from $5,000 to $3,500 per year, for purchases made after March 5, 1996. The purchase amount eligible for the credit was increased to $5,000 in 1998, effective for 1998 and subsequent years.

[37] The decline in the value of this expenditure in 1996 reflects a 30-per-cent decline in the number of claimants and a 45-per-cent decline in the average claim in that year. The increase in the value of this expenditure for 1998 reflects a 30-per-cent increase in the number of claimants and a 25-per-cent increase in the average claim in that year. The value of this tax expenditure in 1999 is based on preliminary information of sales of shares of labour-sponsored venture capital corporations for that year.

[38] This provision was proposed in the 2000 budget.

[39] The decline in this tax expenditure in 1998 reflects a decline in the volume of home sales and in the average home value. The decline in 2000 and 2001 reflects the reduction in the capital gains inclusion rate from three-quarters to two-thirds.

[40] This tax expenditure includes both gifts to the Crown and donations to other charities, as they were treated equivalently in the Income Tax Act beginning in 1997.

[41] This measure was proposed in the 2000 budget. No data are currently available.

[42] This measure was introduced in the 1997 budget for a five-year experimental period and will be reviewed in 2000. The 1997 and 1998 figures are based on income tax data. Consistent with the methodology of tax expenditures, these estimates assume that the measure did not bring forth any incremental donations. They therefore do not measure the full fiscal cost of the measure. Consistent with the legislated expiration of the measure at the end of 2001, no amount is estimated for 2002.

[43] This provision was introduced in the 1999 budget, effective for qualifying retroactive lump-sum payments received after 1994. Cost estimates and projections for 1995 to 1998 reflect the costs associated with qualifying payments received in those years, even though claims were not processed before 2000.

[44] This estimate assumes that the total amount of lottery and horse racing winnings would be included in income and subject to tax. However, there is some uncertainty regarding the proper benchmark tax system in this area. For example, if the benchmark system included taxation of winnings, it would also have to include a deduction for the purchase cost of tickets. A threshold below which winnings would not be taxable may also be necessary, due to the large administrative cost of taxing very small prizes. In addition, proceeds from the sale of lottery tickets are an important source of funds for provincial governments and not-for-profit organizations. As a result, there is already an element of taxation to lottery and gambling proceeds. This estimate is therefore included as a memorandum item only.

[45] The 1996 budget broadened eligibility criteria for claiming this deduction, beginning in 1996. The 1998 budget increased the maximum claim under this provision and extended it to part-time students, beginning in 1998. The 2000 budget proposed to increase limits in respect of persons eligible for the disability tax credit.

[46] The 1998 budget enhanced the moving expense deduction by including certain costs of maintaining a vacant former residence (including mortgage interest and property taxes) and other miscellaneous relocation expenses.

[47] The 1995 and 1996 figures have been revised due to methodological changes in calculations.

[48] This tax expenditure applies to a subset of resource-related deductions. Data was available for 1996, 1997 and 1998 on the volume of reclassified shares, and this data was used to calculate estimates. Due to volatility, the projections for 1999 to 2002 are based on a three-year historical average.

[49] The expected increase in this tax expenditure is in line with the historical trend.

[50] This measure was introduced in the 1998 budget. The 1999 budget extended this measure to all taxpayers, effective July 1, 1999. The 1999 budget increased the tax expenditures associated with the basic personal credit and the spousal/equivalent-to-spouse credits and eliminated the supplementary low-income credit.

[51] From 1996 to 1998, the basic personal credit was $6,456. The 1999 budget increased the credit by $675, effective July 1, 1999, raising its value to $7,131. (Since this credit was implemented half way through the year, the effective basic credit in the 1999 taxation year was $6,794, or half the proposed annual increase). The 2000 budget proposed to fully index this credit, effective January 1, 2000, raising its value to $7,231 in the 2000 taxation year.

Table 2
**Corporate income tax expenditures***

| | Estimates | | Projections[1] | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995[2] | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Tax Rate Reductions** | | | | | | | | |
| Low tax rate for small businesses[3] | 2,465 | 2,385 | 2,715 | 2,860 | 3,240 | 3,405 | 3,415 | 3,340 |
| Low tax rate for manufacturing and processing (M&P)[4] | 1,515 | 1,350 | 1,600 | 1,655 | 1,875 | 1,970 | 1,810 | 1,765 |
| Low tax rate on general income of small businesses[5] | – | – | – | – | – | – | 60 | 95 |
| Low tax rate for credit unions | 33 | 42 | 39 | 39 | 43 | 44 | 44 | 43 |
| Exemption from branch tax for transportation, communications, banking and iron ore mining corporations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Exemption from tax for international banking centres | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Tax Credits** | | | | | | | | |
| Investment tax credits | | | | | | | | |
| Scientific research and experimental development investment tax credit | 980 | 980 | 990 | 1,030 | 1,130 | 1,170 | 1,215 | 1,260 |
| Atlantic investment tax credit[6] | 87 | 120 | 175 | 180 | 125 | 130 | 135 | 140 |
| Special investment tax credit[7] | 19 | – | – | – | – | – | – | – |
| Investment tax credits carried back | 57 | 87 | 83 | 86 | 90 | 93 | 96 | 100 |
| Investment tax credits claimed in current year but earned in prior years | 855 | 735 | 810 | 895 | 985 | 1,085 | 1,190 | 1,310 |
| Political contribution tax credit | S | S | S | S | S | S | S | S |
| Canadian film or video production tax credit[8] | 10 | 40 | 70 | 85 | 105 | 110 | 115 | 120 |
| Film or video production services tax credit[9] | – | – | S | 55 | 57 | 59 | 60 | 62 |

* **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the companion document, *Tax Expenditures: Notes to the Estimates/Projections*, for a discussion of the reasons for this.**

Table 2
**Corporate income tax expenditures** *(cont'd)*

| | Estimates | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| **Exemptions and Deductions** | | | | | | | | |
| Partial inclusion of capital gains[10] | 595 | 620 | 925 | 680 | 720 | 920 | 1,070 | 1,110 |
| Royalties and mining taxes | | | | | | | | |
| Non-deductibility of Crown royalties and mining taxes[11] | -320 | -400 | -400 | -325 | -400 | -410 | -420 | -430 |
| Resource allowance[11] | 435 | 505 | 505 | 410 | 505 | 510 | 525 | 540 |
| Earned depletion | 48 | 71 | 54 | 40 | 30 | 20 | 10 | S |
| Deductibility of charitable donations | 96 | 140 | 140 | 150 | 175 | 180 | 190 | 190 |
| Deductibility of gifts to the Crown | 8 | 8 | 8 | 9 | 10 | 11 | 11 | 11 |
| Interest on small business financing loans | S | S | S | S | S | S | – | – |
| Non-deductibility of advertising expenses in foreign media | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of provincial assistance for venture investments in small business | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Deferrals** | | | | | | | | |
| Accelerated write-off of capital assets and resource-related expenditures[12] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Allowable business investment losses[13] | 29 | 33 | 35 | 36 | 39 | 40 | 42 | 45 |
| Holdback on progress payments to contractors[14] | 40 | 10 | 25 | 25 | 25 | 30 | 30 | 30 |
| Available for use | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Capital gains taxation on realization basis | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Expensing of advertising costs | 7 | 6 | 25 | 25 | 25 | 25 | 25 | 30 |
| Deductibility of contributions to mine reclamation and environmental trusts | S | S | S | S | S | S | S | S |
| Deductibility of countervailing and anti-dumping duties[15] | – | – | – | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deductibility of earthquake reserves[15] | – | – | – | 3 | 16 | 17 | 18 | 19 |
| Cash basis accounting | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Flexibility in inventory accounting | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Table 2
**Corporate income tax expenditures** *(cont'd)*

| | Estimates | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | ($ millions) | | | | | | | |
| Deferral of income from grain sold through cash purchase tickets | 7 | S | S | 3 | 3 | 3 | 3 | 3 |
| Deferral of income from destruction of livestock | S | S | S | S | S | S | S | S |
| Deferral through use of billed-basis accounting by professionals | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **International** | | | | | | | | |
| Non-taxation of life insurance companies' world income | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Exemptions from non-resident withholding tax[16] | | | | | | | | |
| Copyright royalties | 57 | 60 | 63 | 66 | 69 | 72 | 76 | 80 |
| Royalties for the use of, or right to use, other property[17] | 51 | 150 | 160 | 165 | 175 | 185 | 190 | 200 |
| Interest on deposits | 445 | 445 | 470 | 490 | 500 | 515 | 535 | 535 |
| Interest on long-term corporate debt | 665 | 665 | 700 | 730 | 745 | 770 | 795 | 795 |
| Dividends | 52 | 66 | 80 | 83 | 94 | 90 | 93 | 96 |
| Management fees | 17 | 18 | 19 | 19 | 20 | 21 | 23 | 24 |
| Exemption from Canadian income tax of income earned by non-residents from the operation of a ship or aircraft in international traffic | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Other Items** | | | | | | | | |
| Transfer of income tax room to provinces in respect of shared programs | 695 | 715 | 860 | 895 | 1,020 | 1,075 | 1,120 | 1,125 |
| Interest credited to life insurance policies | 73 | 75 | 75 | 79 | 83 | 87 | 91 | 96 |
| Non-taxation of registered charities and other non-profit organizations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Income tax exemption for provincial and municipal corporations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-taxation of certain federal Crown corporations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Aviation fuel excise tax rebate[18] | – | – | n.a. | n.a. | n.a. | n.a. | – | – |
| Surtax on the profits of tobacco manufacturers | -63 | -67 | -70 | -70 | -70 | -70 | -70 | -70 |
| Resource sector tax rate[19] | – | – | – | – | – | – | -33 | -41 |
| Temporary tax on the capital of large deposit-taking institutions[20] | -34 | -50 | -52 | -58 | -66 | -74 | -83 | n.a. |

Table 2
**Corporate income tax expenditures** *(cont'd)*

| | Estimates | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | | | ($ millions) | | | |
| **Memorandum Items** | | | | | | | | |
| Refundable taxes on investment income of private corporations | | | | | | | | |
| Additional Part I taxes[21] | -80 | -190 | -465 | -475 | -495 | -495 | -545 | -590 |
| Part IV tax[22] | -830 | -990 | -895 | -925 | -955 | -985 | -1,020 | -1,050 |
| Dividend refund[23] | 1,185 | 1,450 | 1,610 | 1,660 | 1,720 | 1,770 | 1,830 | 1,890 |
| Net expenditure[24] | 275 | 270 | 250 | 260 | 270 | 290 | 265 | 250 |
| Refundable capital gains for investment corporations and mutual fund corporations[25] | 145 | 170 | 185 | 190 | 205 | 195 | 195 | 205 |
| Loss carry-overs[26] | | | | | | | | |
| Non-capital losses carried back | 650 | 715 | 800 | 1,010 | 1,025 | 1,065 | 1,135 | 1,250 |
| Non-capital losses applied to current year[27] | 2,870 | 2,035 | 2,495 | 2,245 | 2,655 | 2,675 | 2,700 | 2,710 |
| Net capital losses carried back[28] | 69 | 40 | 80 | 81 | 82 | 85 | 90 | 100 |
| Net capital losses applied to current year[29] | 115 | 205 | 235 | 180 | 150 | 150 | 155 | 155 |
| Farm losses applied to current year | 18 | 8 | 14 | 14 | 15 | 16 | 17 | 17 |
| Deduction of meals and entertainment expenses | 190 | 215 | 210 | 220 | 230 | 240 | 250 | 260 |
| Large corporations tax | | | | | | | | |
| Threshold[30] | 515 | 540 | 550 | 560 | 570 | 585 | 595 | 605 |
| Exempt corporations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Patronage dividend deduction | 215 | 210 | 235 | 255 | 290 | 305 | 305 | 305 |
| Logging tax credit | 28 | 29 | 29 | 29 | 29 | 29 | 30 | 31 |
| Deductibility of provincial royalties (joint venture payments) for the Syncrude project (remission order)[31] | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deductibility of royalties paid to Indian bands | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Non-resident-owned investment corporation refund | 105 | 25 | 59 | 68 | 63 | 64 | 76 | 66 |
| Investment corporation deduction | S | S | S | S | S | S | S | S |
| Deferral through capital gains rollovers | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Deduction for intangible assets | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Tax exemption on income of foreign affiliates of Canadian corporations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

***Notes:***

[1] Unless otherwise indicated in the footnotes, changes in the projections from those in last year's edition of this document result from changes in the explanatory economic variables upon which the projections are based.

[2] The 1995 figures are based on final data and may differ from the figures in last year's edition of this document, which were based on preliminary data.

[3] The increase from 1996 to 1997 reflects an increase in the projected level of small business profits. The slight increase in 2001 and reduction in 2002 results from the change in the benchmark rate from 29.12 per cent to 28.12 per cent as of January 1, 2001. The impact of the change in the benchmark federal tax rate only partially affects estimates for taxation year 2001 since many firms will report income for this taxation year that will be partly earned in calendar year 2000.

[4] The increase from 1996 to 1997 reflects an increase in the projected level of M&P profits. The decline in 2001 and 2002 results from the change in the benchmark rate from 29.12 per cent to 28.12 per cent as of January 1, 2001. The impact of the change in the benchmark federal tax rate only partially affects estimates for taxation year 2001 since many firms will report income for this taxation year that will be partly earned in calendar year 2000.

[5] This measure was announced in the 2000 budget and is effective January 1, 2001.

[6] The projected cost of the tax expenditure after 1998 is lower because a large portion of this tax expenditure relates to the Hibernia offshore oil project, which has completed its investment phase. No new offshore projects have been included in the projections. The tax expenditure could be higher if a project were to proceed.

[7] New investments (other than those that were grandfathered) did not earn this credit after December 31, 1994. Credits not claimed in 1994 and prior years may be carried forward. However, they are included in the forecasts for investment tax credits claimed in a current year but earned in prior years.

[8] Taxation year 1995 is a transition year. Some films are financed through tax shelter deductions for accelerated capital cost allowance.

[9] This measure was introduced in 1997.

[10] The increase in this tax expenditure in 1997 reflects a projected increase in capital gains. The increase in the expenditure in 2000 reflects the reduction in the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000 as proposed in the 2000 budget.

[11] Negative tax expenditures due to non-deductibility of Crown royalties and mining taxes and positive tax expenditures due to the resource allowance are highly dependent upon the level of activity in the resource industries. The large increase from 1995 to 1996 and the sharp drop in 1998 reflect volatility in international prices for crude oil and minerals.

[12] This tax expenditure consists of the fast write-off of certain capital assets, including capital equipment used for scientific research and experimental development, of resource exploration and development expenditures and of energy conservation and efficiency equipment. See *Tax Expenditures: Notes to the Estimates/Projections* for an explanation of why no figures have been calculated.

[13] The amount of this tax expenditure can fluctuate from year to year depending upon the amount of current-year losses and the availability of income against which to apply these losses.

[14] The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon the level of construction activity.

[15] This measure was introduced in 1998.

[16] These estimates and projections are based on the benchmark assumption that no behavioural response would occur after the hypothetical removal of existing withholding tax exemptions. This assumption is particularly difficult to sustain for this type of tax, as indicated in *Tax Expenditures: Notes to the Estimates/Projections*, which means that the amounts shown in the table should not be regarded as estimates and projections of the revenue gain that would be realized from the hypothetical removal of the listed withholding tax exemptions.

[17] The large increase from 1995 to 1996 can be attributed to protocol changes to the Canada-U.S. tax treaty.

[18] This measure is effective for the years 1997 to 2000 inclusive.

[19] The resource sector tax rate is scheduled to remain at 29.12 per cent as of January 1, 2001, since this sector benefits from a number of special deductions such as the resource allowance when the allowance exceeds provincial royalties, accelerated exploration and development expenses and fast write-offs for certain capital assets. The negative tax expenditure results from a change in the benchmark federal tax rate to 28.12 per cent as of January 1, 2001.

[20] This measure was first introduced in the 1995 budget and extended in subsequent budgets. The measure was last extended in the 2000 budget and is scheduled to expire after October 31, 2001, pending completion of a review of the surcharge.

[21] An additional refundable Part I tax on investment income of 6 2/3 per cent was introduced effective July 1995.

[22] Estimates and projections were not previously provided for this item. The 1993 and 1994 estimates are -$770 million and -$790 million respectively. The Part IV tax on dividends was increased from 25 per cent to 33 1/3 per cent effective July 1995.

[23] Estimates and projections were not previously provided for this item. The 1993 and 1994 estimates are $870 million and $1,010 million respectively. The rate at which the refundable tax on hand is refunded was changed from $1 for every $4 of dividend paid to $1 for every $3 of dividend paid, effective July 1995.

[24] Net expenditure represents the total tax expenditure associated with this measure. Estimates and projections were not previously provided for this item. The 1993 and 1994 estimates are $100 million and $220 million respectively.

[25] The projected reduction in this tax expenditure in 2000 and 2001 reflects a reduction in the capital gain inclusion rate announced in the 2000 budget as well as the reduction in the benchmark tax rate effective January 1, 2001.

[26] The impact of loss carry-overs can fluctuate significantly from year to year depending upon the amount of current and prior years' losses and the availability of income against which to apply these losses.

[27] The decrease in this amount from 1995 to 1996 results from a decrease in the amount of losses of prior years being applied.

[28] The decrease in this amount from 1995 to 1996 results from a decrease in the amount of losses available for carry-back to reduce income of prior years.

[29] The increase in this amount from 1995 to 1996 results from an increase in the amount of income against which to apply losses of prior years.

[30] The large corporations tax rate increased to 0.225 per cent from 0.2 per cent, effective February 28, 1995. Therefore, the value of the exempt threshold was increased for taxpayers.

[31] The cost of the Syncrude Remission Order ("Order Respecting the Remission of Income Tax for the Syncrude Project," P.C. 1976-1026, May 6, 1976 [C.R.C. 1978 Vol. VII, c. 794]) has not been estimated for this edition. The costs of this particular remission order are now published annually in the Public Accounts of Canada (ISBN 0-660-177792-7).

Table 3
**GST/HST tax expenditures**[*] [†]

| | Estimates | | | | Projections | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | | ($ millions) | | | | |
| **Zero-Rated Goods and Services** | | | | | | | | |
| Basic groceries[1] | 2,610 | 2,720 | 2,885 | 2,990 | 3,130 | 3,300 | 3,470 | 3,630 |
| Prescription drugs[1] | 240 | 250 | 265 | 275 | 285 | 300 | 320 | 330 |
| Medical devices[1] | 70 | 75 | 80 | 80 | 85 | 90 | 95 | 100 |
| Agricultural and fish products and purchases | S | S | S | S | S | S | S | S |
| Certain zero-rated purchases made by exporters (including those by Export Distribution Centres) | S | S | S | S | S | S | S | S |
| Non-taxable importations (including those by Export Distribution Centres) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Zero-rated financial services | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Tax-Exempt Goods and Services** | | | | | | | | |
| Residential rent[1] | 1,190 | 1,240 | 1,310 | 1,360 | 1,420 | 1,495 | 1,575 | 1,650 |
| Health care services[1] | 585 | 610 | 650 | 680 | 710 | 750 | 790 | 825 |
| Education services (tuition)[1] | 545 | 570 | 605 | 630 | 660 | 695 | 730 | 760 |
| Child care and personal services[1] | 135 | 140 | 150 | 155 | 160 | 170 | 180 | 190 |
| Legal aid services | 30 | 30 | 30 | 35 | 40 | 40 | 40 | 45 |
| Ferry, road and bridge tolls[1] | 5 | 5 | 5 | 5 | 5 | 5 | 10 | 10 |
| Municipal transit[1] | 95 | 100 | 105 | 110 | 110 | 120 | 125 | 130 |
| Exemption for small businesses | 120 | 125 | 130 | 140 | 145 | 155 | 160 | 160 |
| Quick method accounting | 135 | 150 | 160 | 165 | 175 | 185 | 195 | 205 |
| Water and basic garbage collection services[1] | 150 | 160 | 170 | 175 | 185 | 195 | 200 | 210 |

[*] **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the companion document, *Tax Expenditures: Notes to the Estimates/Projections*, for a discussion of the reasons for this.**

[†] GST/HST is used throughout the publication as the HST replaced the GST in Nova Scotia, New Brunswick, and Newfoundland and Labrador on April 1, 1997. For the purpose of this publication, the HST represents only the federal component (i.e., 7 per cent) in the participating provinces.

Table 3
**GST/HST tax expenditures** *(cont'd)*

| | Estimates | | | | Projections | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | | ($ millions) | | | | |
| Domestic financial services | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Certain supplies made by non-profit organizations | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Tax Rebates** | | | | | | | | |
| Housing rebate[2] | 355 | 435 | 475 | 455 | 495 | 520 | 560 | 600 |
| New residential property rebate | – | – | – | – | – | 15 | 40 | 45 |
| Rebate for book purchases made by qualifying institutions[3] | – | $ | 25 | 25 | 30 | 30 | 30 | 30 |
| Rebate for foreign visitors on accommodation[4] | 55 | 65 | 70 | 75 | 75 | 80 | 80 | 80 |
| Rebates for municipalities[5] | 480 | 475 | 495 | 505 | 505 | 505 | 505 | 505 |
| Rebates for hospitals[5] | 270 | 260 | 255 | 260 | 260 | 260 | 260 | 260 |
| Rebates for schools[5] | 295 | 290 | 290 | 295 | 295 | 295 | 295 | 295 |
| Rebates for universities[5] | 115 | 105 | 110 | 110 | 110 | 110 | 110 | 110 |
| Rebates for colleges[5] | 60 | 55 | 50 | 55 | 55 | 55 | 55 | 55 |
| Rebates for charities | 165 | 165 | 160 | 160 | 165 | 175 | 180 | 190 |
| Rebates for non-profit organizations | 50 | 55 | 45 | 45 | 45 | 45 | 50 | 50 |
| **Tax Credits** | | | | | | | | |
| Special credit for certified institutions | n.a. | n.a. | – | – | – | – | – | |
| GST/HST credit | 2,820 | 2,850 | 2,895 | 2,860 | 2,900 | 3,040 | 3, 065 | 3,155 |
| **Memorandum Items** | | | | | | | | |
| Meals and entertainment expenses[6] | 95 | 100 | 100 | 100 | 105 | 110 | 115 | 120 |
| Rebate to employees and partners | 60 | 70 | 70 | 75 | 75 | 80 | 85 | 90 |
| Residential and other personal-use real property | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

***Notes:***

1 The Sales Tax Model used to generate these estimates and projections has been revamped and is now based on the 1996 national input-output tables from Statistics Canada and the latest release of the national income and expenditure accounts. The new statistical data has resulted, in some instances, in significant revisions to the tax expenditures. This largely reflects the update from 1990 I-O tables to the 1996 tables and the historical revision which took place in 1999.

2 The housing rebate is based on information provided by Statistics Canada. The rebate has been revised downward for most years largely as a result of new information on housing prices.

3 This measure was introduced in October 1996.

4 The methodology for estimating this tax expenditure was derived as part of the review of the Visitors' Rebate Program conducted during 1997 and has been updated to reflect more recent information.

5 Since the value of this tax expenditure is influenced by provincial budgetary decisions, projected values are simply the value estimated for 1998.

6 The numerical approach used to derive the tax expenditure figures is tightly integrated with the tax expenditure estimates reported for the personal and corporate tax system.

## Part 2

# TAX EVALUATIONS AND RESEARCH REPORTS

# DEFINING TAX EXPENDITURES

# I. INTRODUCTION

The principal goal of a tax system is to raise revenue in order to finance government operations and programs. As the 1997 federal budget explained: "In raising revenue, it is essential for governments to use a tax system that is fair...."[1] Governments also use a variety of tax instruments – credits, exemptions, rate reductions, deductions, deferrals, rebates and carry-overs – to achieve an array of social and economic objectives.

These deviations from a benchmark tax system, or tax concessions, are often described as tax expenditures, implying that the tax system is being used to deliver assistance that could have been provided through spending. This raises two issues. First, identifying tax concessions is not a simple exercise. Second, this approach labels all tax concessions as tax expenditures and hence as a substitute for program spending.

A simple example highlights the complexities involved in identifying tax concessions. Consider two countries, both having a statutory tax rate of 30 per cent. Suppose Country A has an additional, lower, 15-per-cent tax rate on incomes that are less than $30,000 dollars. Now suppose that Country B, instead of the second 15-per-cent tax rate, allows a variety of tax credits, deductions and exemptions, targeted at those with incomes below $30,000. As a result of these tax concessions, assume that Country B effectively has the same tax burden for all citizens as Country A.

Despite the two tax structures having identical taxation outcomes, the list of tax concessions for Country A will differ greatly from that of Country B. Because common practice allows the tax rate structure to be taken as part of the benchmark, Country A will have no tax concessions to report, while Country B will have a long list. This is obviously not reasonable, and becomes even more problematic if all tax concessions are simply assumed to be substitutes for program spending.

The example suggests that determining tax expenditures should be a two-step, rather than a one-step, process. The first step should determine tax concessions starting with a benchmark tax system. The second step should determine, using an appropriate set of criteria, whether the tax concession is deliverable on the spending side. If it is, then it is a tax expenditure; if it is not, then it is effectively a tax reduction. This two-step approach implies that tax expenditures are a subset of tax concessions: hence, all tax expenditures are tax concessions; not all tax concessions are tax expenditures; and tax concessions that are not tax expenditures are effectively tax reductions.

[1] Department of Finance Canada, *Budget 1997: Budget Plan*, (Ottawa: Public Works and Government Services Canada, 1997), p. 145.

Recognition that not all tax concessions are tax expenditures is evident in the tax expenditure reports of Germany, the United States and the United Kingdom.[2] They refer to tax expenditures as "subsidies" or "special exceptions in the tax code that serve programmatic functions"[3] in their efforts to identify tax expenditures within tax concessions. Further, each of these three countries uses a form of the two-step approach to identify tax expenditures. This distinction between tax concessions and tax expenditures is pursued in this paper using an approach similar to that of Germany, the United States and the United Kingdom. It is worth emphasizing that this paper does not seek to limit the number of tax concessions that are reported, but rather to provide guidance with respect to their interpretation. Accordingly, the goals of the paper are to:

- summarize the range of issues in the literature on determining tax concessions; and
- develop criteria for determining when a tax concession should be classified as a tax expenditure.

In section II of this paper, various theoretical approaches to defining the benchmark are discussed. Section III identifies elements of the tax structure that are absolutely necessary and, as such, are considered components of the benchmark. Section IV examines the issue of specific types of tax concessions necessary to the overall structure of the tax system, and highlights those that are in place for this reason. Section V discusses the experiences of other countries in defining and reporting tax expenditures. Section VI develops possible criteria for determining which tax concessions are tax expenditures. Section VII presents a classification system for tax expenditures based on these criteria. Some concluding remarks complete the paper.

## II. The Tax Concession Debate: What Is the Benchmark?

A tax concession represents a deviation from a benchmark tax system. However, there is a lack of consensus in determining the benchmark tax system. This lack of consensus has been attributed to the fact that "in a many-consumer economy, there is an indefinitely large number of efficient tax structures, no one of which has prior claim to being the best."[4] As a result, a variety of possible benchmarks have been developed. These benchmarks vary in their treatment of certain fundamental components such as

---

[2] Tax expenditure reports are important publications as they permit comparisons between tax expenditures and direct spending measures. The extent and nature of the uses of tax expenditure information varies among countries. Most countries use it for debating spending and taxation issues in parliamentary committees. Germany also uses the tax expenditure report to examine sectoral subsidies, while the United Kingdom uses it to reconsider the form and method of tax relief and its cost. In the United States it contributes to tax reforms. And in Belgium tax expenditure information is even an element in labour negotiations.

[3] Budget of the United States Government, *Analytical Perspectives: Fiscal Year 1998* (Washington: U.S. Government Printing Office, 1997), p. 84.

[4] Robin Boadway and Frank Flatters, "Tax Expenditures and Alternatives for Evaluating Government Activities Conducted Through the Tax System," *Tax Expenditures and Government Policy*, ed. Neil Bruce (Kingston: John Deutsch Institute for the Study of Economic Policy, 1988), p. 80.

the tax unit, tax base and tax period. Each benchmark is unlike the others in how it defines one or more of these components and, therefore, each benchmark produces a different set of tax concessions.

The following paragraphs discuss the possible approaches to defining the benchmarks for each of the personal income tax, the corporate income tax, and the Goods and Services Tax/Harmonized Sales Tax (GST/HST). They will also illustrate how the list of tax concessions changes with each benchmark.

## *Personal Income Taxation*

### Haig-Simons Comprehensive Income Base

When the discussion of the tax expenditure concept began in the 1960s, there was some consensus that the appropriate norm for the personal income tax was the Haig-Simons (or Schanz-Haig-Simons) comprehensive income base.[5] The Haig-Simons Comprehensive Income Base requires the taxation of real current additions to purchasing power, or real increases in wealth. Under a Haig-Simons base, all income must be included as taxable income. This means that income from all sources, including labour income, rents, dividends, interest, transfers, accrued capital gains, imputed rent, value of household services, gifts and inheritances, must be taxed uniformly. In addition, Haig-Simons allows for the deduction of expenses to earn income and requires indexation for inflation in order to measure real, not nominal, additions to wealth.

The problem with using the Haig-Simons ideal is that it is difficult to implement. Even though theory dictates that no forms of income should be tax-exempt, in practice there may exist measurement, compliance or collection issues preventing full and comprehensive income taxation. As a result, a long list of tax concessions would result. For example, measurement problems are likely to be encountered when attempting to tax the imputed value of household services. Not only would it be difficult to place values on certain types of household services, but it would also be virtually impossible to accurately measure the amount of time each individual spent doing these activities. Under the Haig-Simons base, non-taxation of household services would be considered a tax concession, the value of which would be unknown.

Even when measurement is not the issue, compliance problems may lead to an unduly long list of tax concessions. For instance, the Haig-Simons base requires the taxation of all gifts received and allows for the deduction of all gifts given. However, it is highly unlikely that gifts under a certain value will actually be reported and included in taxable income. Furthermore, even if the non-taxation of gifts were reported as a tax concession, it is unlikely that the calculated tax concessions would be very accurate as it is impossible to know the true value of lost tax revenue resulting from unreported gifts.

---

[5] David E. Wildasin, "Tax Expenditures: The Personal Standard," *Tax Expenditures and Government Policy*, ed. Neil Bruce (Kingston: John Deutsch Institute for the Study of Economic Policy, 1988), p. 137.

Another practical problem with using the Haig-Simons base as the benchmark involves tax collection. For example, Haig-Simons taxation demands that capital gains be taxed on accrual, not on realization. Lost tax revenue from taxation upon realization is considered a tax concession. However, tax collection becomes a problem when taxing capital gains on accrual. The tax payable from accrued capital gains is usually measurable (with the possible exception of works of art), but taxpayers may encounter problems raising funds to pay the tax owing, as even though gains have accrued, taxpayers do not realize the gains until they sell the assets. This means that, in order to pay the tax, they may be forced to sell assets they would otherwise retain. In this case the tax would alter economic behaviour and result in an inefficient allocation of economic resources. For this reason, despite the Haig-Simons comprehensive income mandate, taxation of accrued income actually leads to problems of economic distortions. Auerbach suggests a solution for this tax collection problem whereby the tax liability could be realized only upon sale of the asset, but interest could be charged for the deferral of tax from the date of accrual of the gain.[6] Under these conditions, tax collection is less of a problem, but the cost of tax administration – tracking gains and losses and calculating interest – is substantially higher.

## Labour Income Base

An alternative income base would involve considering only labour income. Under a labour income base, unlike a comprehensive income base, income from investment and savings is exempt from taxation. Investments are made from after-tax labour income, but the returns generated by the investment are not subject to tax. This means that, under the labour income base, the present discounted values of both current and future consumption are the same. As a result, the appeal of the labour income base is that it does not distort decision making between present and future consumption.

Unlike some other approaches, a labour income base treats human capital in the same manner as other forms of capital: it considers human capital as a non-registered asset. That is, investment in human capital is made from after-tax dollars, but no tax is imposed on future gains, such as increased earnings, that result from the investment.[7] Thus, it does not allow for the deduction of investment expenses in human capital, such as tuition fees and other educational expenses. Furthermore, it requires the taxation of potential earnings that are foregone in order to increase the value of human capital, by going to school, for example. In addition, increases in earnings attributed to the accumulation of human capital are not subject to taxation.[8] Deviations from these rules are regarded as tax concessions. In the real world, both the taxation of foregone earnings and the non-taxation of increased earnings due to human capital investment are infeasible and

---

[6] A. J. Auerbach, "Retrospective capital gains taxation," *American Economic Review* 81 (1991), pp. 167-178.

[7] Non-registered treatment of assets is in contrast to registered treatment of assets, where a tax deduction is allowed for the initial investment but, when the asset is sold, both the initial investment and accrued gains are subject to taxation as long as they are not transferred into other registered assets.

[8] James B. Davies and France St. Hilaire, *Reforming Capital Income Taxation in Canada: Efficiency and Distributional Effects of Alternative Options* (Ottawa: Economic Council of Canada, 1987) p. 36.

impractical. Accordingly, the resulting list of tax concessions due to the treatment of human capital as a registered, rather than non-registered, asset would be of limited use for comparison and policy purposes as the required treatment of human capital under the labour income base is impractical.

## Consumption Base

Instead of using an income base for taxation, some theorists advocate the use of a consumption or expenditure base. Under a consumption base, people are taxed on what they spend rather than on what they earn, where spending is measured as the difference between income and saving. The benefit of a consumption tax base is that it does not discriminate between taxpayers that receive and spend income at different times. As a result, some argue that the consumption base may better reflect a taxpayer's ability to pay than does the Haig-Simons base.[9]

Under a consumption tax base, all assets, including owner-occupied housing, are given registered treatment. Using the example of owner-occupied housing, deductions for down payments, mortgage payments, and spending on repairs, maintenance and improvements would be allowed, and proceeds from the sale of the owner-occupied housing would be subject to taxation. Imputed rent, however, would be taxed, as it is part of consumption. In current practice, the reverse is considered the norm: no deductions are allowed and proceeds from the sale of owner-occupied housing are not subject to tax. As a benchmark, the consumption tax base may be problematic in certain cases as it has the potential to raise measurement and compliance issues when determining imputed rent and spending on maintenance and repairs.

## Lifetime Consumption Base

A lifetime consumption base differs from an annual consumption base in that it allows income averaging and taxation based on lifetime consumption. The lifetime consumption base does not require taxation of imputed household services (as in the case of Haig-Simons) or registered treatment of human capital (as in the cases of both the labour income base and the Haig-Simons base). Nevertheless, several problems arise when comparing the existing tax structure to the lifetime consumption base. This base requires the taxation of gifts and inheritances, as they are deemed part of consumption. The problems this raises are similar to those found under the Haig-Simons base. Secondly, despite its theoretical appeal, in reality it is virtually impossible to impose taxes on total lifetime consumption. As a result, if the benchmark were taken to be lifetime consumption, then tax concessions would be calculated as deviations from the lifetime consumption benchmark. These calculated tax concessions would have little meaning and would not be usable for the purposes of comparison with direct spending. Compounding this problem is the difficulty involved in annualizing taxes for the purpose of comparison with actual tax collections. For these reasons, adoption of the pure lifetime consumption base may not be ideal.

---

[9] Davies and St. Hilaire, *Reforming Capital Income Taxation in Canada*, p. 7.

## *Corporate Income Taxation*

Determining the base of taxation for corporate income leads to a smaller range of options and views. There are two principal trains of thought regarding corporate income taxation.

### Non-Taxation

Some theorists believe that corporate taxes may be superfluous and that only the individual should be taxed. In this case, the ideal tax base would require taxation of all sources of income at the individual level. The alternative approach is set out in the 1997 Canadian budget, which provides three reasons for business taxation.[10] First, businesses benefit from public goods and services, and so businesses should pay taxes in order to compensate for "the cost of a public good or service that confers a benefit on the firms."[11] Second, without a corporate tax, individuals would be able to defer paying taxes on capital gains or income by investing in a corporation and having the income or capital gains accrue within the corporation. Third, by taxing corporations, income that is earned in Canada and accrues to foreigners and foreign corporations operating in Canada can be taxed.

### Haig-Simons Comprehensive Income Base

Those who favour taxing the income of the corporate sector often refer to the Haig-Simons income base as the appropriate corporate benchmark tax structure. The Haig-Simons base is the same for corporate income as for personal income in that it requires the taxation of comprehensive income with adjustments for inflation. The corporate income tax can be viewed as a tax on economic rents and on the return on equity capital. This translates into a withholding tax on shareholders' Haig-Simons income.

There are two main problems with adopting the Haig-Simons base as the ideal corporate tax base. First, Haig-Simons requires indexation for inflation so that only real gains in wealth are subject to taxation. Although this may be a desired feature of the tax base, there are serious problems implementing it because it is difficult to accurately measure real gains as opposed to nominal gains. Second, it makes no provision for the cyclical nature of business. Taxes are assessed based on real accrued gains in wealth. The Haig-Simons base indicates that losses should be subtracted from gains so that only real increases in wealth are subject to taxation. However, Haig-Simons does not address what happens if losses exceed gains and there is a net decrease in wealth. The logic of Haig-Simons implies that if losses exceeded gains, a credit would be granted for the negative income tax due. However, there is no clear indication as to whether

---

[10] Department of Finance Canada, *Budget 1997: Tax Fairness* (Ottawa: Public Works and Government Services Canada, 1997), p. 16.

[11] Vijay Jog and Jack M. Mintz, "Business Tax Expenditure Accounts: Their Purpose and Measurement," *Tax Expenditures and Government Policy*, ed. Neil Bruce (Kingston: John Deutsch Institute for the Study of Economic Policy, 1988), p. 191.

Haig-Simons would require this. Without a provision for the cyclical nature of business, carry-overs allowed in the tax system may be considered tax concessions when compared with the Haig-Simons benchmark, even though they are in place to deal fairly with corporate losses and to recognize the existence of the business cycle.

## Goods and Services Tax/Harmonized Sales Tax

### Consumption Base

The GST/HST is a value-added tax, broadly based on consumer goods and services. The most logical benchmark is, therefore, a consumption base. Under a consumption base, all goods and services consumed are subject to a uniform tax rate. If any good or service is either excluded from the tax or subject to a tax rate different than the statutory rate, there will be a tax concession. This benchmark allows no provisions for horizontal or vertical equity as every individual is subject to the same tax rate on all goods and services.

## Summation

The examination of the theoretical arguments for the use of various tax bases and their impact on the determination of tax concessions has revealed that there is no single correct benchmark. With the exception of the GST/HST, where the use of the consumption base is clearly the most appropriate benchmark, there are plausible arguments for and against defining the benchmark in each of the aforementioned ways. As a result, none of these proposed benchmarks is ideal in its pure form. The use of any of these bases in their pure form would create tax concessions that would be of limited use for the intended function of tax expenditure reports – comparative analysis and policy examination.

The difficulty of selecting a benchmark tax structure is integral to the difficulty in defining a tax concession, since a change in the benchmark results in a change in what is classified as a tax concession. While it is generally accepted that a tax system should be efficient, equitable, simple to administer and easy to comply with, theory provides no indication as to which requirement should take precedence and no rule as to how to balance these criteria. The focus of this paper, however, is not on selecting the benchmark. The discussion of the difficulties involved in selecting a benchmark tax structure was provided to demonstrate that the intricacies of defining tax expenditures begin before the notion of a tax expenditure is even discussed. For the purposes of this paper, the benchmark tax structure is taken from *Tax Expenditures: Notes to the Estimates/Projections.*[12]

[12] Department of Finance Canada, *Tax Expenditures: Notes to the Estimates/Projections* (Ottawa: Public Works and Government Services Canada, 2000).

## III. Components of the Benchmark

This paper does not propose criteria for defining tax concessions, but rather takes the tax concessions as they have been defined in *Tax Expenditures: Notes to the Estimates/Projections*. It recognizes that there are certain elements that make up every tax system, which must be defined and understood as integral to the structure of the system. These components do not constitute tax concessions. The Canadian tax system defines these components – the tax unit, the taxation period, the tax rate structure and the treatment of inflation – as follows.

### Tax Unit

While it is accepted that there must exist a definition of the tax unit, the "ideal" measurement of the tax unit is not dictated by theory. In the Canadian personal income tax system, the benchmark tax unit is defined to be the individual. An alternative to this might be to define the tax unit as the family, as is possible in the United States. The existing Canadian tax system levies taxes based on the income of an individual, even though some tax concessions depend on family income. However, if the benchmark tax unit were defined to be something other than the individual, such as the family, but in practice the unit of taxation remained the individual, then the calculated tax concessions would be of very limited use for policy purposes.

In the case of the corporate income tax system, the benchmark tax unit is the corporation. This definition of the corporate tax unit is most highly correlated to the treatment of the tax unit in the existing tax system. Even though there are occasional measures to recognize inter-corporate ties, such as the deferral of capital gains through rollover provisions, in general, taxes and tax provisions are based on the single, legal, corporate entity. If anything but the single corporation were used as the benchmark tax unit to calculate and report tax expenditures, the amounts would be of limited policy relevance and would be difficult to use for comparison purposes because the unit of taxation in practice would remain the individual corporation.

Under the GST/HST, the ideal tax unit is taken to be the consumer of goods or services in Canada, whether the consumer is an individual person, business or corporation. One of the related tax provisions, the GST/HST credit, depends on family income. In this respect it more closely resembles an expenditure program, for which qualification is generally based on family income. In the existing system, however, all other provisions deal with the consumer as defined above.

### Taxation Period

The tax period is another integral part of the benchmark tax structure. In Canada, the benchmark tax period for the personal income tax and for the GST/HST is the calendar year. For the corporate income tax structure, the taxation period is the fiscal period ending in the calendar year. This is more of a convention than a rule, established for ease of accounting. It is, however, consistent with the Haig-Simons benchmark for income taxation. As noted earlier, proponents of the lifetime consumption benchmark argue that annual income does not accurately define ability to pay, as income and consumption patterns change throughout the lifetime of an individual. In their view, the taxation period should be considerably longer than a year in order to allow for income averaging.

## Tax Rate Structure

It is also necessary for the benchmark to define the tax rate structure. Deviations from the benchmark rate structure would then be considered tax concessions. For the Canadian corporate income tax, the benchmark rate is defined to be the same as the current standard rate of corporate income tax, including the surtax and the provincial abatement. Any preferential rates, such as the low tax rate for manufacturing and processing and the low rate for small businesses, represent a departure from the benchmark and are considered to be tax concessions. The GST/HST also has a flat benchmark tax rate. Any deviation from the statutory rate of 7 per cent is a tax concession.

In the Canadian personal income tax system, the existing progressive tax structure, including surtaxes, is considered the benchmark tax structure. Although, in order to be consistent with the corporate income tax and the GST/HST, it would be best to use one single rate as the benchmark, if this were followed in the personal income tax, problems regarding the measurement and interpretation of other tax concessions would arise. If the benchmark rate were set at a flat rate, as it is in the corporate income tax and the GST/HST, then the progressive structure of the personal income tax system would lead to large tax concessions. Furthermore, if the benchmark tax rate diverged greatly from the existing tax rate structure, then any tax concessions would not be accurately comparable to direct spending. Inclusion of the progressive structure in the benchmark rate means that vertical equity is recognized as a key component of the personal income tax benchmark.

## Treatment of Inflation

For the purposes of identifying tax concessions, the treatment of inflation plays a minimal role. In contrast, when estimating the value of tax concessions, how the benchmark treats inflation is important. For example, as Canada moves to a fully indexed personal income tax system in 2000, the value of the tax concessions associated with credits and personal amounts will automatically increase in nominal terms. In addition, a measure in the tax system requiring only two-thirds of capital gains to be included in taxable income is designed partly to help avoid taxation of purely inflationary gains. But unless the true difference between nominal and real gains is one-third of total capital gains, there will be either a positive or negative tax concession. The exact difference between nominal and real gains, however, is a measurement issue and can be dealt with when estimating the value of tax concessions.

The indexed system that is in place as of 2000 is close to the Haig-Simons benchmark, which posits that only real additions to wealth should be taxed. Thus, under that benchmark, lack of indexation would be considered a negative tax concession. In contrast, strict adherence to proportional taxation on a consumption base does not require any indexation.

## IV. Other Tax Features Included in the Benchmark

In addition to the basic components of the benchmark, there are certain other features that are elements of a fair tax system. Measures to include these features should be considered part of the benchmark and should not be considered tax concessions.

### Measures to Reduce or Eliminate Double Taxation of Income

It is obvious that the same earned income should not be taxed more than once. This may, however, effectively arise if that income is taxable under two tax systems. In order to determine whether or not a tax measure helps to reduce double taxation, it is essential to examine the integration of the various tax systems. For example, the dividend gross-up and credit allow individuals to gross up dividends received from taxable Canadian corporations, include this amount in income and then claim a tax credit for a portion of the grossed-up amount. This provision recognizes that some of the taxes on dividend income have already been paid at the corporate level and that this income should not be taxed again under the personal income tax. Thus, the gross-up and credit reduce double taxation of income and increase the neutrality of the overall tax structure; therefore, they should not be considered as tax concessions. Despite attempts to reduce double taxation, under-integration may still exist. As a result, any remaining instances of double taxation of income should be considered negative tax concessions. In contrast, if the dividend gross-up and tax credit were calculated to be greater than the tax on dividends paid by the corporation, then a situation of over-integration would exist and this would be considered a tax concession.

Similar reasoning lies behind the foreign tax credit. It recognizes that income earned abroad has already borne tax and so provides a tax credit to avoid this same income being taxed again in Canada. However, if the credit were larger than the real income tax paid, then the difference would be considered a tax concession. In contrast, if the credit were smaller than the actual income tax paid, then a situation of under-integration of the tax systems would exist. In this case, the difference between the tax credit and the actual income tax paid would be considered a negative tax concession.

### Loss Carry-Overs

Loss carry-overs recognize the cyclical nature of business and acknowledge that losses suffered in one period may be offset by gains in another. Income in one year may not be an accurate indicator of ability to pay taxes due to substantial losses in a previous year. Consequently, carry-overs allow losses to be applied to past or future income in order for individuals, businesses and corporations to smooth income to a certain degree over the business cycle. In Canada, tax provisions that recognize the impact of business cycles on income include the carry-over of non-capital losses, the carry-over of net capital losses, and the carry-over of farm losses and restricted farm losses.

### Deduction of Expenses to Earn Income

In general, businesses act to maximize profits, where profits are defined to be revenue less the costs of generating that revenue. It is generally accepted that taxes should be assessed on income net of expenses incurred to earn income, rather than gross income.

Under both the personal and corporate income tax systems, legitimate expenses incurred to earn income are deductible from gross income in order to determine the appropriate base of income taxation. Nevertheless, the definition of legitimate expenses in the personal income tax is subjective and, in some cases, controversial. Certain expenses such as child care expenses, attendant care expenses, and meals and entertainment expenses are viewed by some as legitimate costs of doing business, but are seen by others as spending resulting from personal choices. Consequently, the classification of certain expenses as tax provisions essential to the benchmark tax structure is not absolute and indisputable.

## V. TAX EXPENDITURES: COUNTRY EXPERIENCES

An examination of tax expenditure reports across countries shows that their structure, costing and contents differ widely, revealing the absence of a universally accepted definition of what constitutes a tax expenditure. In Canada, the current reporting of tax expenditures is very broad, covering any tax concession that is not considered one of "the most fundamental structural elements of each tax system" and implying a very wide definition of tax expenditures.[13] In addition, if there is any doubt as to whether or not a tax concession fits this definition, revenue losses resulting from the reduction are still reported, but under a category entitled "memorandum items." Not every country produces as comprehensive a list of tax concessions as Canada does. In order to determine the definition of a tax expenditure in Canada, it may be useful to consider the definitions of tax expenditures currently in use in other countries.

The United Kingdom attempts to divide tax reliefs into two categories. Those reliefs that are alternatives to, and have similar consequences as, public spending are referred to as tax expenditures. Those forms of tax relief that are either an integral part of the tax structure or simplify administration or compliance are called structural reliefs. Structural reliefs include measures such as the personal allowance and double taxation relief. Tax expenditures include measures such as the exemption of capital gains on the sale of a principal residence and the exemption of the first £8000 of reimbursed relocation packages provided by employers. However, the government acknowledges that "the distinction between structural reliefs and tax expenditures is not always straightforward,"[14] and include a third category of tax reliefs, which consists of tax concessions that combine elements of both the structural and expenditure categories. Into this somewhat open-ended category, they put tax concessions such as age-related allowances and the tax exemptions for child benefits and disability living allowances.

France defines a tax expenditure as a tax measure that results in a loss of tax revenue for the state and a corresponding easing of the tax burden on the taxpayer that would not have occurred under the application of general tax law. Nevertheless, additional criteria including duration, general applicability and neutrality are also used to define tax expenditures in cases of uncertainty. Cases of uncertainty, however, are rare.

---

[13] Department of Finance Canada, *Tax Expenditures, 1999*, p. 33.

[14] OECD, *Tax Expenditures: Recent Experiences* (Paris: Head Publication Services OECD, 1996), p. 98.

Unlike France, Germany does not have a formal definition of tax expenditures. It examines every tax concession within the context of the tax system as a whole to determine whether or not it is a subsidy. Consideration is also given to the scope of the tax measure: "The larger the circle of taxpayers which benefits from a tax concession, the less it tends to be considered a subsidy in the report."[15] In addition, Germany uses consistency as a criterion for identifying tax expenditures. The issue here is whether a tax measure is applied consistently or in an ad hoc manner. Those provisions that are considered ad hoc are classified as tax expenditures.

With consistency as the only criterion, however, even if a tax concession brings the tax system closer to the benchmark tax structure, it could still be considered a tax expenditure. Bruce[16] cites the example of the (now defunct) Canadian investment income deduction as an ad hoc response to a flaw in the existing tax structure in that, without the deduction, increases in investment income due only to inflation would have been taxed. In this case, an ad hoc provision actually moves the system closer to the Haig-Simons ideal, but under the German classification system it would be considered a tax expenditure. Bruce therefore concludes that "consistency is not a sufficient condition" for determining whether or not a tax concession is a tax expenditure; the tax concession must also accord with the norm.[17]

Germany also states the official reason for the tax concession. After determining the list of tax expenditures, it classifies them by sector and then further classifies them by the aim of the tax measure. By denoting the purpose of the tax measure as one of support, adjustment aid, productivity aid or other purpose, Germany attempts to ascertain the amount of government financial support given to each objective.

Although according to the United States Senate Committee on the Budget, tax expenditures "may, in effect, be viewed as spending programs channelled through the tax system,"[18] the U.S. definition of tax expenditures is somewhat unique among Organisation for Economic Co-operation and Development (OECD) countries. Unlike other OECD countries, the United States uses two different tax structures to report two sets of tax expenditures: the normal tax structure and reference law. Tax expenditures under the normal tax structure are similar, but not identical, to those reported in Canada. They include any deviation from the basic structure of the tax system, where the basic structure includes both a standard deduction and deductions for expenses to earn income, and is not limited to a specific rate structure or unit of taxation. The normal tax base,

---

[15] OECD, *Tax Expenditures: Recent Experiences*, p. 66.

[16] Neil Bruce, "Pathways to Tax Expenditures: A Survey of Conceptual Issues and Controversies," *Tax Expenditures and Government Policy*, ed. Neil Bruce (Kingston: John Deutsch Institute for the Study of Economic Policy, 1988), p. 29.

[17] Ibid.

[18] Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, prepared for the Committee on the Budget, United States Senate (Washington: U.S. Government Printing Office, 1997), p. 2.

however, strays from a Haig-Simons comprehensive income base as it allows for the following: income being taxable when realized rather than on an accrual basis, corporate income being taxed separately from individual income, and the tax system being based on nominal values, i.e., there is no adjustment for inflation.

Tax expenditures under reference law are more limited. They more closely reflect the existing tax laws and consist only of "special exceptions in the tax code that serve programmatic functions."[19] In order for a tax concession to be classified as a tax expenditure under reference law, two conditions must be satisfied. First, "absent the special provision, the tax laws provided general rules to enable a taxpayer to determine his income tax due and payable," where the general rules constitute the reference law.[20] That is, the tax concession must not be necessary for the calculation of tax payable. Second, the tax concession must apply "to a sufficiently narrow class of transactions or transactors" such that its objectives could be realized through program spending using government funds.[21]

The reference law baseline differs from the normal baseline in several ways. Reference law recognizes as part of the baseline the varying tax rates within the corporate tax structure. Thus, the maximum statutory tax rate is not recognized as the benchmark, as it is under the normal baseline. As a result, preferential tax rates applied both to the first $10 million of corporate income and to capital gains are not considered tax expenditures under reference law. Reference law also does not include in its benchmark the taxation of transfer payments from the government to individuals. Exclusion of these cash transfers from income, therefore, does not result in tax expenditures under reference law. In general, tax expenditures under the reference law baseline are also tax expenditures under the normal tax base line, but the reverse is not always true. Examples of tax concessions considered tax expenditures under the normal tax base line but not under the reference law baseline include accelerated depreciation on rental housing, buildings other than rental housing, and equipment and machinery; and exclusion of scholarship and fellowship income.

The United Kingdom, France, Germany and the United States all maintain the common goal of establishing a more accurate definition of a tax expenditure. The actual definitions developed by each country vary considerably. The United Kingdom and Germany, however, introduce an interesting method of determining tax expenditures: examining each tax concession to ascertain whether it is an alternative to public spending or a subsidy. This idea of defining a tax expenditure as an alternative to public spending or as a subsidy indicates that, in order for a tax concession to be a tax expenditure, the concept of deliverability must be examined.

---

[19] Budget of the United States Government, *Analytical Perspectives: Fiscal Year 1998* (Washington: U.S. Government Printing Office, 1997), p. 84.

[20] OECD, *Tax Expenditures: Recent Experiences*, p. 108.

[21] OECD, *Tax Expenditures: Recent Experiences*, p. 108.

## VI. Developing the Criteria for Defining Tax Expenditures

In determining the criteria for defining tax expenditures, both theory and practice provide useful insights. In Surrey's definition, tax expenditures are "governmental financial assistance programs...carried out through special tax provisions rather than direct Government expenditures."[22] Together with the United Kingdom definition of tax expenditures as alternatives to public spending and the German definition of tax expenditures as subsidies, this means that tax expenditures are direct spending programs delivered through the tax system.[23] A reasonable criterion is that a tax concession should be considered a tax expenditure if it can be delivered equivalently through program spending. "Delivered equivalently" means that a tax concession be delivered outside the tax system without altering program or administrative costs or modifying the distribution of benefits. If a tax concession cannot be delivered equivalently it is not a tax expenditure, but rather a tax reduction.

### Distribution of Benefits

The most difficult aspect of "equivalent deliverability outside the tax system" ("deliverability" for short) to satisfy is retention of the same distribution of benefits. Conceptually, the distribution of benefits can be exactly the same only in the case of refundable tax credits. Under both the corporate and personal income tax systems, in theory, non-refundable tax credits may be deliverable outside the tax system because they do not affect the calculation of taxable income. For example, if the same people who claimed a non-refundable credit under the tax system were instead to receive the benefit under a spending program, then the distribution of benefits would be the same under both systems. Because the credit is non-refundable, however, it is only valuable to those with positive taxable income. Consequently, if an individual's total non-refundable tax credits exceed total taxes payable, then some credits will not be used up. An individual who qualifies for a credit, but cannot claim the full credit due to insufficient taxable income, does not receive the benefit.

For example, suppose Individual A claims the basic personal credit in the amount of $1,229.27 (17 per cent of $7,231). However, Individual A's calculated income tax owing is only $1,000. Because the credit is non-refundable, Individual A can claim only $1,000 of the credit. The remaining $229.27 cannot be claimed due to insufficient levels of taxable income and income tax payable. As a result, Individual A will not receive the full benefit of the tax credit.

If this basic personal tax credit were replaced by a direct spending program that retained the same distribution of benefits, Individual A would still only be able to receive partial benefits. However, a different taxpayer, Individual B, with income tax payable in the amount of $2,000 would be able to claim the credit in its entirety. To match this distribution using direct spending would involve designing a program that provided low

---

[22] Stanley Surrey, *Pathways to Tax Reform* (Cambridge, Mass.: Harvard University Press, 1973), p. 6.

[23] Budget of the United States Government, *Analytical Perspectives*, p. 84.

or zero benefits to lower-income recipients and higher benefits to higher-income recipients. This type of program is unlikely to be acceptable in practice for vertical equity reasons.

If, instead, the spending program granted Individual A full benefits of $1,229.27, then clearly the distribution of benefits would change. Not only would Individual A, who received only partial benefits under the tax benefit, now receive full benefits under the spending program, but so would other individuals who previously received zero benefits under the tax concession. Adopting this approach to direct delivery would result in a program whose benefits would be like those of a refundable tax credit. That is, more people would qualify for this benefit. Consequently, for some tax concessions like non-refundable credits and deductions, the distribution of benefits may change, making those tax concessions only potentially deliverable outside the tax system.

## Program Cost

For many tax concessions there are conceivable replacement spending programs which provide the same total benefit to the overall population. This allows program costs to remain constant. However, program costs are highly dependent on the distribution of benefits. If the primary goal is to retain the same program costs, then it is likely that the distribution of benefits will change and, consequently, the original objectives of the tax concession will not be achieved. Only if the same individuals receive the same benefits will the objectives be achieved at the same program cost. As shown above, if the distribution of benefits changes, it is most likely that more people will qualify for the benefit under the spending program than through the tax concession. Thus, if the distribution of benefits changes, then the original objectives of the tax concession will only be achieved at a higher program cost.

Some tax credits are deliverable outside the tax system as the program costs are almost identical and the distribution of benefits is likely to be the same. For instance, the tuition fee credit, accompanied by its infinite carry-forward, can be viewed as almost equivalent to program spending. Although it is non-refundable, the credit can be carried forward indefinitely to offset future taxable income. Only if the qualifying individual never has taxable income will the benefit from the credit not be realized.

Despite the carry-forward, the tuition credit is not fully, but "almost fully" deliverable outside the tax system. If the tuition credit were delivered outside the tax system, the benefits would be realized in the same year that the tuition was paid. However, for an individual that did not use up the tuition credit in the tax system due to insufficient income, but carried it forward one or more years, the value of the credit would not be identical to the value of a credit claimed in the year that tuition costs were incurred. The value of the credit claimed in future years would have to be discounted to the present value and would be less than the value of a credit claimed in the year the costs were incurred. In this case, the program costs of delivering a tuition benefit would be slightly higher than the costs of the tuition credit in the tax system. As the difference in benefit levels and program costs between the two delivery methods is very small, the tuition credit combined with the carry-forward provision can be considered deliverable outside the tax system. This argument applies to all non-refundable credits with a carry-over provision.

However, delivery of a tax concession through direct spending cannot always be achieved at the same or even similar program cost. Direct delivery of concessions such as the spousal credit, equivalent-to-spouse credit, dependant credit, age credit and basic personal credit would likely result in increased program costs or, if the distribution of benefits is considered, a change in the distribution of benefits. Because these tax concessions are all non-refundable credits without a carry-over provision, they are wasteable credits. That is, if the credit is not claimed in full in the year it is earned, then the full benefit from the credit will never be realized. In order for program costs to remain the same under direct delivery, it is likely that the administration costs of determining the exact benefit for each individual would be prohibitive.

## Administration Cost

For a tax concession to be fully deliverable outside the tax system, it needs to have similar administration costs. In some cases, such as the refundable Canada Child Tax Benefit, the administration costs will be similar, as the tax concession could be converted into a program, and delivered as it is currently, in the form of a cheque.

However, some tax concessions could undergo very substantial increases in administration costs if they were removed from the tax system and delivered directly. For example, a spending program cannot deliver the provision for non-taxation of capital gains on principal residences without very significant increases in administration costs. The recipients of the benefit change from year to year and the amount of the tax benefit depends on the marginal tax rates faced by the taxpayer. Because the value of the benefit varies from taxpayer to taxpayer depending on their position in the tax rate structure, large expenses would have to be incurred in order to determine both the qualifying individuals and the value of the benefit to each individual.

In general, in the personal income tax system, the administration costs of delivering deductions and exemptions as direct spending would be very substantial. The purpose of both deductions and exemptions in the tax system is to "arrive at an accurate assessment of income, i.e., to determine the proper tax base for a taxpayer."[24] Deductions and exemptions reduce gross income to taxable income and, therefore, apply and have value only to those with positive gross income. However, due to the progressive nature of the personal income tax system, the value of a deduction or exemption varies according to the individual's marginal tax bracket. The value of a deduction or exemption is highest for those in the top marginal tax bracket and falls to zero for those who do not pay any taxes.

For example, the provision for non-taxation of employer-paid insurance benefits for group private health and dental plans exempts the employee from paying tax on these benefits. The exemption is considered undeliverable because of the very fact that it is used to determine taxable income, and hence, the value would vary across individual employees according to their marginal tax brackets. As a result, it would be virtually impossible to duplicate the benefits from this tax concession in a spending program.

[24] Wildasin, "Tax Expenditures: The Personal Standard," p. 155.

Consequently, deductions and exemptions in the personal income tax system are considered infeasible for delivery outside the tax system because of overwhelming administration costs.

Unlike the personal income tax system, the corporate income tax system and the GST do not contain progressive tax structures. As a result, deductions and exemptions have the same value to all who qualify for them and the administration costs of delivering them outside the tax system would not be prohibitive.

## VII. CLASSIFICATION SYSTEM

Each tax concession can be assessed based on the above criteria to determine how deliverable it is outside the tax system. Because of the variability in types of tax concessions and the limited ability of theory to direct their classification, it is not possible to consider each tax concession as simply deliverable or non-deliverable. Consequently, it will not be possible to classify each tax concession into just two categories, those being tax expenditures and other tax concessions. Due to varying levels of deliverability, there are some uncertain cases that require individual determination. As a result, the system of classification that emerges from this set of deliverability criteria consists of four levels, but with a degree of uncertainty about the appropriate classification of some provisions.

### Type I Tax Expenditures

The first classification level comprises those tax concessions that are closest to direct expenditures. They are broadly deliverable outside the tax system as their delivery through direct spending leads to no significant alteration in the distribution of benefits and no substantial changes in program and administration costs. In general, Type I tax expenditures consist of refundable tax credits and rebates, as qualification for these tax provisions and their delivery through direct spending would remain the same as their delivery through the tax system.

### Type II Tax Expenditures

Type II tax expenditures are tax concessions that are deliverable outside the tax system with a similar distribution of benefits and program costs. Direct delivery of these tax concessions will, however, result in measurable increases in administration costs. In general, Type II tax expenditures comprise non-refundable tax credits with a carry-over and/or transferability. In addition, because of the single tax rate in the corporate tax system, Type II tax expenditures also include many exemptions and deductions in the corporate tax structure. Under the GST/HST, Type II tax expenditures comprise most zero-rated goods and services.

### Type III Tax Expenditures

These tax concessions, if delivered through direct spending rather than the tax system, would significantly increase both administration costs and program costs and would substantially change the distribution of benefits. In general, Type III tax expenditures

include non-refundable tax credits that have no provision for transferability or carry-over, and therefore might not be claimed in full. In the case of the GST/HST, type III tax expenditures consist of the tax-exempt goods and services which, if delivered directly, would alter the distribution of benefits and increase program costs.

### Tax Reductions

Tax reductions are those tax concessions that simply cannot be delivered outside the tax system without incurring substantial and prohibitive increases in administrative costs as well as changes in the distribution of benefits and program costs. Not only would the distribution of benefits and program costs change, as in the case of Type III tax expenditures, but the value of these tax reductions would vary depending on the marginal tax bracket faced by the individual. In general, the tax reduction category comprises deductions, deferrals and exemptions in the personal income tax system. In the corporate income tax system, tax reductions consist of deferrals. Deferrals often have variable lengths, and thus the benefit of the deferral may vary from corporation to corporation.

### Part of the Benchmark

This category consists of those tax concessions which were identified earlier in this paper as essential components of the tax system, because they reduced double taxation, ensured the correct measurement of income or dealt with business losses. Because these reductions are essential elements of the tax system, the deliverability criteria do not apply to them.

## VIII. Concluding Remarks

This paper highlights the fact that the definition of a tax expenditure is not absolutely precise and that a universally accepted definition does not exist. For this reason, the tax expenditure report provides as comprehensive a set of information as possible. This avoids getting into a controversy about whether an item is a tax expenditure or not. Analysts have found this approach useful.

While some analysts define a tax expenditure as being any deviation from a benchmark tax structure, this paper shows that a deviation from a benchmark can either be a tax reduction or program spending delivered through the tax system. This suggests the need for a two-step approach to defining tax expenditures. The first step requires the identification of tax concessions – deviations from the benchmark tax structure. The second step involves determining which tax concessions are tax expenditures

The analysis clarifies an approach to classifying tax expenditures with the goal of helping readers to analyze the information currently provided in the tax expenditure report. This approach could also be used to change how information on tax expenditures is presented. Comments are invited as to whether such a reclassification would be useful, bearing in mind that the same amount of information on deviations from the benchmark will continue to be provided.

# THE ALTERNATIVE MINIMUM TAX

# I. INTRODUCTION

In response to criticisms that there were too many high-income individuals paying little or no taxes, the Government announced in the May 1985 budget its intention to introduce a minimum tax that would take effect on January 1, 1986. The purpose of the alternative minimum tax (AMT), as it became known, was to achieve a fairer tax system by reducing the extent to which high-income filers paid little or no income tax. This was to be accomplished by ensuring that high-income individuals were not able to systematically use tax preferences to substantially reduce or eliminate taxes payable. This paper examines the extent to which the AMT has achieved its objective for the period between January 1, 1986 and December 31, 1997.

# II. BACKGROUND

## What is the AMT?

The AMT is targeted towards individuals with high incomes who are able to use tax preferences to substantially reduce or eliminate their taxes in a given year.[1] In general, the AMT increases the tax filer's taxable income by disallowing various tax preferences. In place of these preferences, a $40,000 exemption is granted. The net taxable income is then taxed at a 17-per-cent rate to arrive at the minimum amount of tax that must be paid. The tax filer must pay the greater of the minimum amount and the amount of regular taxes that would be paid in the absence of the AMT. The minimum amount over and above the regular taxes paid can be carried over and used to reduce regular taxes payable to a level no lower than the minimum amount payable in a subsequent year. Example 1 briefly illustrates how the AMT works. This example, and all subsequent examples, are based on the 1997 tax system.

**EXAMPLE 1 – How the AMT Works**

| | Regular Tax | AMT |
|---|---|---|
| | ($) | ($) |
| Total Income | 250,000 | 250,000 |
| Deductions | 125,000 | |
| Taxable Income | 125,000 | 250,000 |
| AMT Exemption | | 40,000 |
| Net Taxable Income | 125,000 | 210,000 |
| Tax on Income | 31,812 | 35,700 |
| AMT Carry Forward | | 3,888 |

## Review of the 1985 Discussion Paper

The Government released a discussion paper[2] with the May 1985 budget for consultation before implementing a minimum tax. The paper reviewed the extent to which high-income individuals paid little or no income tax during the 1970s and early 1980s, examined the reasons why this occurred and set out the general framework for how a minimum tax should operate.

---

[1] The AMT also applies to most trusts. It is not applicable to individuals who are bankrupt or deceased.

[2] Department of Finance Canada, *A Minimum Tax for Canada*, budget papers (Ottawa: Public Works and Government Services, 1985).

The paper observed that only a small percentage of tax filers had high incomes and paid little or no taxes. Furthermore, few high-income individuals managed to pay no taxes for more than a year (none for more than six consecutive years). The paper also noted that the dividend tax credit was a major reason for high-income individuals not paying income tax. Other reasons included deductions for carrying charges in excess of investment income, the partial taxation of capital gains and deductions for business losses claimed on their tax returns. Social policy items such as registered retirement savings plan (RRSP) deductions were found to be of secondary importance when compared to investment items.

The paper reviewed three possible forms that a minimum tax could take: an AMT, an add-on minimum tax and a limit on tax preferences.[3] The AMT was eventually chosen since it was more easily targeted towards high-income earners who pay little tax and did not interfere with tax calculations for the rest of the population. The remainder of this section reviews some of the arguments made in the discussion paper regarding the appropriate structure of an AMT.

### *Exemption Level*

While the choice of the exemption level was somewhat arbitrary, it had to be high enough to exempt the majority of taxpayers who had low incomes and/or few preference items, but low enough to catch high-income individuals who used preferences to offset large amounts of their income.

### *AMT Tax Rate*

Like the exemption level, the rate had to be "high enough to ensure that substantial levels of income did not go untaxed, while low enough to recognize that a low regular tax liability may be the result of legitimate incentives."[4] The paper argued that the AMT rate should not exceed 17 per cent, which was equal to one-half the top marginal rate at the time. The reason given was that this was equivalent to the top rate on capital gains, which had a 50-per-cent exclusion rate at the time. Presently, the AMT rate is equal to the statutory rate for the lowest tax bracket and the rate used for most non-refundable credits.

### *Choice of Preference Items*

The discussion paper laid out two criteria in choosing preferences that would be included in the AMT base. The first was the degree to which a preference was seen to create a potentially inappropriate or excessive tax preference. The second was the complexity and administrative effort associated with capturing any preference for the AMT base. The preferences that were chosen are discussed in detail in the next section.

---

[3] An AMT has a separate structure from the regular tax system in which various preferences are disallowed. An add-on minimum tax is based on the use of a specified list of preferences, and the amount of tax is simply added to regular taxes payable. A limit on tax preferences means that preferences are limited directly within the regular tax system. For more information see the 1985 discussion paper.

[4] Department of Finance Canada, *A Minimum Tax for Canada*, p. 19.

## The AMT in Practice

### *How the AMT Is Calculated*

In general, the AMT disallows preferences that can be used to generate losses that offset other sources of income.[5] When calculating adjusted taxable income for AMT purposes, the amounts claimed for these preferences are added to regular taxable income. These preferences include the following:

- losses due to claiming capital cost allowance (CCA) or carrying charges[6] on investments in film or rental or leasing property;[7]
- losses from limited partnerships or tax shelter partnerships;
- deductible amounts with respect to registered tax shelter properties that are not included in the AMT base elsewhere; and
- losses due to resource expenditures, depletion allowances and carrying charges related to resource properties and flow-through shares.

When claiming a loss from previous years, any portion of that loss due to any of the preferences mentioned above must also be added to taxable income under the AMT.

The AMT also adds the non-taxable portion of capital gains[8] to the taxfiler's income.[9] In addition, two other deductions are disallowed by the AMT: the deduction for home relocation loans and the stock option and shares deduction.[10]

Dividends are included in the adjusted taxable income at their cash value, and no dividend tax credit is given.[11] In addition, allowable business investment losses are 100-per-cent deductible under the AMT rather than 75-per-cent deductible. This provides symmetric treatment of capital gains and business investment losses.

---

[5] A complete list of preferences and whether or not they are included in the AMT base is presented in Appendix 2.

[6] Carrying charges are interest expenses and other expenses related to purchasing investments, such as investment advice and management fees. Interest on investments for which the return can only take the form of a capital gain cannot be claimed.

[7] CCA losses from multiple-unit residential buildings were also disallowed when these losses could be used to offset other sources of income. This tax shelter has now been closed.

[8] However, it does not include tax-exempt capital dividends in adjusted taxable income. Capital dividends are the non-taxable portion of capital gains realized at the corporate level that are transferred to shareholders.

[9] Other tax-exempt income, such as the first $3,000 of scholarship income, is not added to the AMT base.

[10] This deduction allows the benefits from employee stock options to be taxed at a preferential rate. The deduction for prospectors and grubstakers, which is reported on the same line on individuals' tax returns, is also disallowed by the AMT.

[11] There is little chance for double taxation of dividends, since removal of the dividend tax credit by itself will not cause an individual to pay minimum tax. See the section entitled "Dividends, Capital Gains and the AMT" for further discussion of this matter.

Most non-refundable tax credits (including charitable contributions and personal and spousal credits) can be used to decrease the minimum amount of tax.[12] Two exceptions are credits that were transferred from a spouse or dependant (e.g., tuition fee credit) and the credit for pension income, which are disallowed for minimum tax purposes. The minimum amount net of the non-refundable credits is compared to the individual's regular basic federal tax. If the minimum amount exceeds the basic federal tax, then the individual must pay the AMT.

In addition, the AMT disallows some other tax credits that are used to decrease regular tax payable: the political contribution tax credit, the investment tax credit, the labour-sponsored venture capital corporations credit, the logging tax credit and the overseas employment tax credit.[13] However, an adjusted foreign tax credit can be used to decrease the amount of minimum tax.

***The Carry-Over Provision***

Any minimum tax over and above regular taxes can be carried over for up to seven years to be used as a credit against future regular taxes. The carry-over can only reduce regular taxes to the minimum amount of tax in future years. This has the effect of reducing the cost of the AMT to the taxpayer. The carry-over is there to ensure that tax incentives put in place for valid economic and social reasons are not undermined by the AMT. It ensures that taxpayers "will be able, in effect, to apply unused deductions and tax credits against their regular tax liability in future years, but in each and every year will never pay less than the minimum tax."[14]

***Changes to the AMT Base***

While the rate and exemption level have not changed since 1986, there have been some changes to the preferences included in the AMT. First, beginning with the 1995 tax year, the AMT tax base was broadened with the addition of losses due to carrying charges on certain investments. Second, the 1998 budget included a measure to remove RRSP contributions and rollovers from the AMT tax base, retroactive to 1994. The latter change was made because many individuals were receiving large severance packages that were being rolled over into RRSPs during the economic restructuring of the 1990s. The large RRSP contributions triggered the AMT. Since retirement savings were important to Canadians, and given the limitations on RRSP contributions already in place, the Government decided that it would be appropriate to remove this preference from the AMT base.

---

[12] Since the basic personal credit and other non-refundable credits are credited at a 17-per-cent rate, this effectively raises the amount of income that is not taxed under the AMT to at least $46,456 in 1997.

[13] The refundable portion of the investment tax credit is allowed for AMT purposes.

[14] Department of Finance Canada, "Minister Announces Minimum Tax," Press Release 85-215, December 4, 1985.

### *Changes Made to Some Preferences Targeted by the AMT*

The Government has been actively eliminating or limiting the use of various preferences targeted by the AMT. Nevertheless, these preferences are still included in the AMT base since there may be losses carried over from previous years. For example, the 100-per-cent CCA provisions on certified films was eliminated in the 1995 budget and replaced with a tax credit for producers. One of the reasons cited in the budget was that the CCA measures were simply tax shelters used by high-income individuals.

In addition, the tax shelter on multiple-unit residential buildings has been eliminated. Before the changes, CCA on these properties created losses that could have been used to offset other forms of income. This provision has now been changed and CCA can only be deducted up to the amount of net income from the property.

## Minimum Taxes in Other Jurisdictions

In Canada the province of Quebec has a minimum tax that is similar to the federal AMT. Internationally, only the United States has a minimum tax similar to the one used in Canada. A number of countries have minimum taxes for corporations (such as a minimum tax on assets) but not for individuals. Some countries in Europe have wealth taxes, some of which are tied to the amount of income tax paid. These taxes can be interpreted as a form of minimum taxation. Norway has a national income tax on gross income for which no deductions are provided which affects only high-income individuals. However, this tax does not apply to capital income.[15] In Germany, limits on the set-off of losses result in a form of minimum taxation for individuals with positive incomes over DM 100,000.[16] A brief discussion of minimum tax measures in other countries can be found in Larin and Jacques.[17] An overview of the Quebec and U.S. versions of the AMT is provided below.

### *The Quebec AMT*

The Quebec AMT was introduced at the same time as the federal AMT and it operates in a similar manner to the federal version.[18] It also targets the same preferences.[19] In Quebec the AMT rate was initially 16 per cent, but was raised to 20 per cent in 1993 and to the current rate of 23 per cent in 1998, which is the rate used for non-refundable

---

[15] International Bureau of Fiscal Documentation, *European Taxation Supplementary Service*, 1999, loose-leaf.

[16] Ibid.

[17] Gilles N. Larin and Marie N. Jacques, "Is the Alternative Minimum Tax a Paper Tiger?," *Canadian Tax Journal*, 42(3) (1994), pp. 804-842.

[18] Note that while other provinces do not have their own AMT, the federal version still applies.

[19] The Quebec AMT also disallows some preferences related only to investments in Quebec. Its treatment of allowable business investment losses is similar to the federal AMT.

tax credits. Quebec also reduced the basic exemption from $40,000 to $25,000 in 1996 as a means of increasing revenue and fairness in the tax system. The Quebec government also excluded RRSPs from its AMT base beginning with the 1997 tax year.

***The U.S. AMT***

The United States has had a minimum tax since 1969. The tax was implemented for the same policy reasons as in Canada. The U.S. originally used an add-on minimum tax but eventually switched to an AMT. The U.S. has a minimum tax for both individuals and corporations.[20] The basic method for calculating the AMT is the same as in Canada. Approximately 700,000 U.S. taxpayers paid $4.5 billion in AMT in 1997.[21]

While the American system is similar to the Canadian one, there are two important differences. First, the Canadian system's non-refundable tax credits (such as the basic personal credit) are separate from the $40,000 AMT deduction. In the U.S. system, the personal exemption is treated as an AMT preference and is added back into taxable income. Second, the Canadian AMT deduction is not phased out at higher incomes. Therefore, the American AMT appears to be stricter than its Canadian counterpart.

There has been a great deal of criticism in the United States regarding the AMT, especially the tax on corporations. Most of this criticism concerns the complexity of the tax and the additional compliance costs (e.g., companies have to calculate depreciation two different ways).

## III. Overall Impact of the AMT

The 1985 press release announcing the AMT stated that the minimum tax "ensures that high-income Canadians will pay a fair share of taxes in each year."[22] This section examines the performance of the AMT for the period 1988 to 1997 to determine if it is working as intended. Since the removal of the RRSP deduction from the AMT base was done on a retroactive basis, the tax return data for those years do not take these changes into account. Nevertheless, through the use of the Personal Income Tax T1 model, some of the effects of removing the RRSP deduction from the base have been determined and they will be noted where appropriate. However, it was not possible to determine the effects on the carry-over amounts of individual filers.

---

[20] While Canada does not have a corporate AMT per se, some tax analysts consider the large corporations tax to be like a minimum tax.

[21] Robert P. Harvey and Jerry Tempalski, "The Individual AMT: Why It Matters," *National Tax Journal*, L(3) (September 1997), pp. 453-473.

[22] Department of Finance Canada, "Minister Announces Minimum Tax."

## Revenue and Number of Filers Affected

### *Before RRSPs Were Removed*

Table 3-1 presents the number of filers and the amount of additional revenue collected by the Government from the AMT. Generally, fewer than 30,000 filers paid additional tax as a result of the AMT each year from 1988 to 1997 with revenue well below $100 million per year between 1989 and 1992. The increase in AMT revenue between 1992 and 1993 is mainly due to the increase in the number of filers paying AMT because of increased use of rollovers into RRSPs. The use of the RRSP preference accounted for only 4 per cent of AMT revenue in 1992 but 31 per cent in 1993 (see Appendix 1, Table A1.3). AMT revenue peaked in 1994, with 42,320 individuals paying a total $197 million in additional tax. Since the lifetime capital gains exemption was being phased out in that year, there was an increase in the amount of capital gains declared, leading to more individuals having to pay the AMT.

Since taxpayers can claim the amount of incremental AMT they pay against future regular taxes, the amount of carry-over applied must be taken into account to determine net AMT revenue. As Table 3-1 indicates, while $1.02 billion in gross AMT revenue was collected between 1988 and 1997, $784 million was claimed back by AMT filers, leaving total net revenue from AMT for the period at $237 million. Gross AMT revenue averaged just over $100 million per annum during the period. However, on a net basis, revenue averaged only $23.7 million. In fact, in 1990 and 1995, the Government paid out more in AMT than it collected. With the exception of 1993 and 1994, net revenue on an annual basis was less than $50 million.

Table 3-1
**Additional Revenue From AMT**

| | Incremental AMT | | Carry-Over Applied | | Annual |
|---|---|---|---|---|---|
| Year | # of Filers | Amount ($) | # of Filers | Amount ($) | Net Revenue ($) |
| 1988 | 17,354 | 115,286,000 | 31,389 | 83,570,000 | 31,716,000 |
| 1989 | 15,102 | 85,874,000 | 23,209 | 71,624,000 | 14,250,000 |
| 1990 | 13,810 | 48,062,000 | 24,762 | 84,776,000 | ( 36,714,000) |
| 1991 | 16,268 | 63,251,000 | 18,726 | 54,677,000 | 8,574,000 |
| 1992 | 17,005 | 64,976,000 | 19,027 | 48,353,000 | 16,623,000 |
| 1993 | 29,125 | 121,516,000 | 23,045 | 58,871,000 | 62,645,000 |
| 1994 | 42,320 | 196,848,000 | 29,444 | 76,591,000 | 120,257,000 |
| 1995 | 28,368 | 118,694,000 | 42,693 | 124,587,000 | ( 5,893,000) |
| 1996 | 28,872 | 100,481,000 | 36,224 | 99,638,000 | 843,000 |
| 1997 | 25,765 | 105,753,000 | 31,014 | 80,945,000 | 24,808,000 |
| Totals | | 1,020,741,000 | | 783,632,000 | 237,109,000 |

### *Effect of RRSP Removal*

Since the 1998 budget measure regarding RRSPs was retroactive to 1994, the revenue shown for 1994 to 1997 is lower than the value shown in Table 3-1. This is shown in Table 3-2. In 1996 the number of filers falls below 10,000 while gross revenue was $58.2 million, just over half of what it was before RRSPs were removed from the base.

Table 3-2
**Effect of Removal of RRSPs on Gross AMT Revenues**

| | Before Removal | | After Removal | |
|---|---|---|---|---|
| Year | # of Filers | Amount $ | # of Filers | Amount $ |
| 1994 | 42,320 | 196,848,000 | 22,334 | 110,963,000 |
| 1995 | 28,368 | 100,481,000 | 11,645 | 76,564,000 |
| 1996 | 28,872 | 118,694,000 | 9,847 | 58,208,000 |
| 1997 | 25,765 | 105,753,000 | 10,640 | 68,884,000 |

## Characteristics of AMT Filers

This section looks at the results for 1997 since it is the most recent year for which data is available and because there were no significant shocks to either the tax system or the economy. It was also fairly representative of the period. Figures 3-1 and 3-2 show the income distribution of AMT filers for 1997 after adjusting for the 1998 budget changes. Of the filers affected, 21 per cent had gross incomes below $100,000 (Figure 3-1) and 48 per cent had gross incomes of $250,000 or more.[23] However, if one considers revenue collected, then the picture changes somewhat (Figure 3-2). In 1997, 94 per cent of AMT revenue was paid by filers who had gross incomes of more than $100,000, with 81 per cent of the revenue coming from filers with gross incomes of $250,000 or more. AMT filers with gross incomes of more than $250,000 paid on average an extra $10,851 in tax because of the AMT in 1997. This is similar throughout the 1988-1997 period.

Figure 3-1
**Income Distribution of AMT Filers, by Number of Filers, 1997**

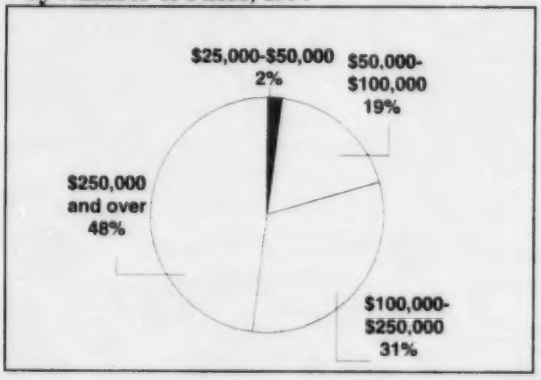
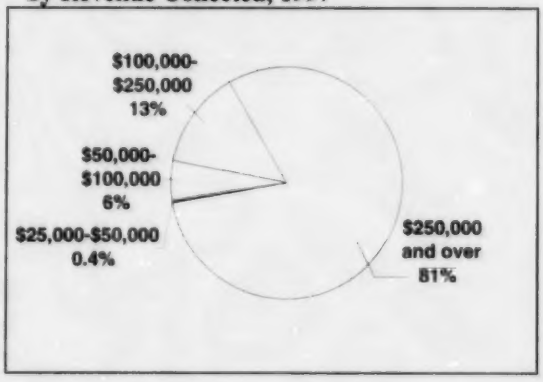



Figure 3-2
**Income Distribution of AMT Filers, by Revenue Collected, 1997**




[23] Gross income is equal to total income for regular tax purposes (line 150 on tax returns) plus the exempt portion of capital gains and losses due to CCA, carrying charges or resource expenditures less the dividend gross-up.

In 1997, there were no filers with gross incomes below $25,000 paying AMT. However, in other years a small number of filers with gross incomes below $25,000 did pay AMT.[24] Apart from this difference, the results are similar between 1994 and 1996.[25] Before 1994, there were a significant percentage of filers with incomes below $100,000 paying AMT. In fact, in 1991 more than half of AMT filers had gross incomes of less than $100,000. Nevertheless, these low-income filers accounted for less than one-half of the revenue collected. On average, between 1988 and 1997, individuals with incomes in excess of $100,000 paid 83 per cent of the AMT revenue while those with incomes in excess of $250,000 contributed 68 per cent of the revenue.

Figures 3-3 and 3-4 present the age distribution and the occupations of AMT filers respectively in 1997. The vast majority of AMT filers are over 40 years of age, with 20 per cent of AMT revenue coming from seniors (Figure 3-3). The percentage of revenue coming from seniors has been rising steadily in recent years. Otherwise, the results are relatively stable over the 1988-1997 period. Figure 3-4 presents the occupations of AMT filers based on the major source of income on their tax returns. Over 70 per cent of AMT revenue came from investors and property owners while 16 per cent came from public and private sector employees. Based on the above discussion, it can be concluded that a typical AMT filer would be an investor or property owner over 40 years of age with an annual income in excess of $100,000.

Figure 3-3
**Age Distribution of AMT Filers, by Revenue Collected, 1997**

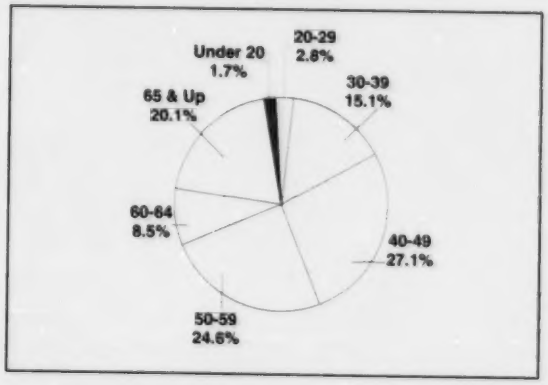
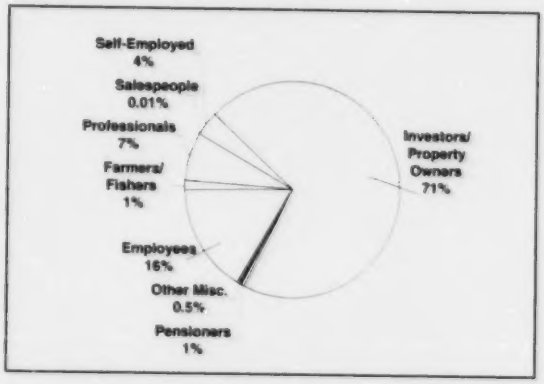



Figure 3-4
**Occupations of AMT Filers, by Revenue Collected, 1997**




[24] In some years there were some filers who had gross incomes of zero or less (due to losses) who paid significant amounts of AMT. This is because the AMT disallows the portion of losses created by CCA, some carrying charges and resource expenses.

[25] Data for previous years can be found in Appendix 1. The removal of RRSPs from the AMT base in the 1994 tax year dramatically reduced the number of AMT filers with incomes between $0 and $50,000.

## The Impact on Individual AMT Filers

This section relies on data from the recently constructed longitudinal tax data file for 1990-1996.[26] The section considers the number of times a filer was taxed under AMT rules during this period and how long it took before such taxes were recouped by these taxpayers.

Table 3-3 presents the number of years that an individual had to pay AMT between 1990 and 1996. Over this seven-year period, 92.14 per cent of AMT filers paid minimum tax only once while a mere 10 filers paid AMT in every year. This suggests that most AMT filers are receiving a windfall gain (such as a capital gain) in one year that triggers AMT.

Another important issue with the AMT is how quickly individuals were able to use the carry-over provision to reclaim the extra tax that they had to pay. To measure this, a sample of filers who paid AMT only once during the period was chosen. Table 3-4 indicates the results for the sample of 9,190 filers who paid minimum tax only in 1990.[27] Over half of these filers had reclaimed the AMT in two years and 70.3 per cent had reclaimed the extra amount of tax they paid in six years. In addition, most of the AMT paid in 1990 by these filers was recouped very quickly. In the first year alone, 68.4 per cent of the tax paid in 1990 was reclaimed. Within two years, only 15.4 per cent of the total amount was remaining. Therefore, those filers who still had not fully claimed back the AMT by 1997 had only a small amount to reclaim in 1997 (an average of $318). If they did not do so, the carry-over would have been lost since the extra tax paid as a result of the AMT can only be claimed up to seven years after it was paid. These findings are similar to those of Larin and Jacques in their study using Quebec AMT data.[28]

Table 3-3
**Number of Years Individuals Paid AMT, 1990-1996**

| # of Years That AMT Was Paid | Number of Filers | % |
|---|---|---|
| 1 | 138,840 | 92.14 |
| 2 | 9,960 | 6.61 |
| 3 | 1,280 | 0.85 |
| 4 | 430 | 0.29 |
| 5 | 130 | 0.09 |
| 6 | 30 | 0.02 |
| 7 | 10 | 0.01 |
| Total | 50,680 | 100.00 |

Table 3-4
**Amount of Carry-Over Remaining for AMT Filers Who Paid AMT Only in 1990**

| Year | Number of Filers | % | $ | % |
|---|---|---|---|---|
| 1990 | 9,190 | 100.0 | 30,153,144 | 100.0 |
| 1991 | 5,130 | 55.8 | 9,526,932 | 31.6 |
| 1992 | 4,050 | 44.1 | 4,647,100 | 15.4 |
| 1993 | 3,560 | 38.7 | 2,972,791 | 9.9 |
| 1994 | 3,210 | 34.9 | 1,962,834 | 6.5 |
| 1995 | 2,910 | 31.7 | 1,914,900 | 4.4 |
| 1996 | 2,730 | 29.7 | 868,555 | 2.9 |

[26] RRSPs were not removed from the data in this section.

[27] While some of these filers may have paid AMT before 1990, only the amount of AMT paid in 1990 is used as a carry-over amount.

[28] Larin and Jacques, "Is the Alternative Minimum Tax a Paper Tiger?"

From the longitudinal data it is clear that, for most minimum tax filers, the AMT is a "once in a lifetime" tax. In addition, the results on the use of the carry-over mechanism support the hypothesis that most filers are able to claim the tax back in the long run and, in fact, claim most of it back in the short run. If the carry-over claimed in each year was discounted at a 5-per-cent rate, the $30.2 million collected from the 9,190 filers in 1990 would have had a present value to the Government of just under $3 million.

## Effectiveness at Reducing Non-Taxable Returns

The main objective of the AMT is to reduce the extent to which high-income individuals pay little or no tax in a given year. This can occur in two ways. First, it can cause individuals with no regular taxes to pay a minimum amount of tax. Second, it can induce individuals to change their behaviour so that they pay a small amount of regular tax over time rather than a large amount of AMT.

The impact of the AMT on the proportion of high income non-taxable returns can be seen in Table 3-5.[29]

Table 3-5
**Number of High-Income Non-Taxable Returns**
**(From the Canada Customs and Revenue Agency's *Tax Statistics on Individuals*)**

| | $100,000 – $250,000 | | $250,000 and Over | | Total Over $100,000 | |
|---|---|---|---|---|---|---|
| Tax Year | Number | % of Returns | Number | % of Returns | Number | % of Returns |
| 1983 | 998 | 1.48 | 178 | 1.90 | 1,176 | 1.53 |
| 1984 | 1,543 | 2.10 | 287 | 2.66 | 1,830 | 2.17 |
| 1985 | 1,277 | 1.41 | 254 | 1.78 | 1,531 | 1.46 |
| 1986 | 530 | 0.51 | 100 | 0.64 | 630 | 0.53 |
| 1987 | 480 | 0.42 | 100 | 0.55 | 580 | 0.44 |
| 1988 | 500 | 0.33 | 140 | 0.46 | 640 | 0.35 |
| 1989 | 920 | 0.49 | 180 | 0.48 | 1,100 | 0.49 |
| 1990 | 1,270 | 0.62 | 250 | 0.69 | 1,520 | 0.63 |
| 1991 | 1,700 | 0.80 | 190 | 0.54 | 1,890 | 0.76 |
| 1992 | 1,930 | 0.88 | 340 | 0.90 | 2,270 | 0.89 |
| 1993 | 1,680 | 0.70 | 250 | 0.57 | 1,930 | 0.68 |
| 1994 | 3,230 | 0.82 | 290 | 0.53 | 3,520 | 0.79 |
| 1995 | 1,520 | 0.59 | 230 | 0.51 | 1,750 | 0.58 |
| 1996 | 1,400 | 0.49 | 310 | 0.58 | 1,710 | 0.51 |
| 1983-85 Average | 1,273 | 1.66 | 240 | 2.12 | 1,512 | 1.72 |
| 1986-96 Average | 1,378 | 0.61 | 216 | 0.59 | 1,595 | 0.60 |

[29] The figures presented in this section are based on total income for tax purposes.

There is an immediate drop in the percentage of non-taxable filers coinciding with the introduction of the AMT in 1986. The drop in high-income non-taxable returns is maintained throughout the period, with the average proportion of high-income non-taxable returns falling 65 per cent between the 1983-85 and the 1986-96 periods. Even though in 1996 there were 1,710 non-taxable filers with total incomes for tax purposes of $100,000 or more, this accounted for only 0.51 per cent of filers in that income group. This suggests that the AMT has been effective at reducing the proportion of non-taxpaying filers at higher-income levels. At the same time, however, other changes in the tax system may have contributed to this decline.

Despite the sharp drop in the share of non-taxable returns, only a fraction of those who have no regular income tax pay minimum tax (Table 3-6). On average, between 1988 and 1996, 27 per cent of high-income filers who had no regular income tax paid minimum tax, with a higher percentage for the subset of individuals with incomes of $250,000 or more. This also points to a change in behaviour – taxpayers made less use of preferences disallowed by the AMT, but still used other preferences and deductions to reduce their tax liability to zero.

Another perspective to consider is the percentage of AMT filers who had to pay some tax but had their taxes increased as a result of the AMT. This is shown for the years 1988-1997 in Table 3-7 for all income levels.[30] On average, 92.4 per cent of AMT filers were already taxable. These individuals were responsible for 88.2 per cent of additional tax collected from the AMT, paying on average an extra $3,333 in tax.

Table 3-6
**Percentage of Filers With No Regular Income Tax Payable Who Paid AMT**

| Year | $100,000-$250,000 | $250,000 and Over | Over $100,000 |
|---|---|---|---|
| 1988 | 22 | 45 | 29 |
| 1989 | 36 | 46 | 38 |
| 1990 | 17 | 35 | 21 |
| 1991 | 18 | 31 | 20 |
| 1992 | 23 | 31 | 24 |
| 1993 | 33 | 49 | 36 |
| 1994 | 21 | 52 | 25 |
| 1995 | 26 | 44 | 29 |
| 1996 | 23 | 33 | 25 |
| Average | 24 | 41 | 27 |

Table 3-7
**Percentage of AMT Filers Who Had Some Regular Tax Payable, 1988-1997**

| | Total (All Income Levels) | | |
|---|---|---|---|
| Year | % of Filers | % of Rev. | Avg. AMT Paid ($) |
| 1988 | 90.8 | 74.4 | 3,347 |
| 1989 | 92.5 | 88.9 | 3,932 |
| 1990 | 93.5 | 89.9 | 2,226 |
| 1991 | 93.4 | 94.1 | 2,582 |
| 1992 | 93.8 | 92.7 | 2,490 |
| 1993 | 95.4 | 95.0 | 2,625 |
| 1994 | 93.8 | 93.6 | 3,274 |
| 1995 | 91.5 | 85.7 | 4,639 |
| 1996 | 89.1 | 82.9 | 3,826 |
| 1997 | 89.8 | 85.4 | 4,390 |
| Average | 92.4 | 88.2 | 3,333 |

[30] The 1999 edition of *Tax Statistics on Individuals* was not available at the time of writing. Therefore, data for 1997 was not included in Table 3-5. With respect to Table 3-6, data was readily available only for the years 1988 to 1996.

# IV. SPECIFIC ISSUES

## What Does It Take to Trigger AMT?

AMT is triggered when minimum tax payable exceeds federal basic tax. In order for this to occur, the amount of preferences added to regular taxable income under the AMT must satisfy two conditions. First, the preferences must, in principle, exceed the $40,000 exemption. However, this is not the case when there are dividends or capital gains. This is because dividends and capital gains use up some of the room that could have been used for other preferences even though they will not trigger AMT by themselves. Second, when the individual has taxable income in the middle- and upper-income brackets, the amount of preferences must be sufficient to compensate for the difference between their statutory marginal tax rate and the AMT tax rate (17 per cent).

Again, this will depend on whether or not the individual has dividends or capital gains. This is because the top marginal rates on dividends and capital gains are lower than the rate for interest or employment income.

Table 4-1 indicates the level of AMT preferences (other than capital gains) that would be required just to equate regular taxes with basic federal tax at various levels of income. If an individual has preferences in excess of this amount, he or she will likely be subject to minimum tax. Individuals with interest or employment income between $100,000 and $500,000 need to have between 51 and 43 per cent of their income reduced by AMT preferences. If the individual has income only from dividends or capital gains, the level of AMT preferences is much less.

Table 4-1

**Amount of Preferences Required Before AMT is Triggered**

| Source | Interest or Employment | | All From Dividends | | All From Cap. Gains | |
|---|---|---|---|---|---|---|
| Gross Income ($) | Preferences Req'd ($) | % of Total Income (%) | Preferences Req'd ($) | % of Total Income (%) | Preferences Req'd ($) | % of Total Income (%) |
| 50,000 | 40,000 | 80.0 | 13,674 | 27.3 | 27,500 | 55.0 |
| 100,000 | 50,525 | 50.5 | 17,067 | 17.1 | 25,525 | 25.5 |
| 150,000 | 70,213 | 46.8 | 21,528 | 14.4 | 32,713 | 21.8 |
| 200,000 | 90,903 | 45.5 | 25,989 | 13.0 | 40,903 | 20.5 |
| 250,000 | 111,592 | 44.6 | 30,450 | 12.0 | 49,092 | 19.6 |
| 300,000 | 132,282 | 44.1 | 34,911 | 11.6 | 57,282 | 19.1 |
| 400,000 | 173,661 | 43.4 | 43,834 | 11.0 | 73,661 | 18.4 |
| 500,000 | 215,041 | 43.0 | 52,756 | 10.6 | 90,041 | 18.0 |

## Dividends, Capital Gains and the AMT

The 1985 discussion paper raised the concern that limiting the dividend tax credit in some way would interfere with the integration of the tax system, causing income to be taxed at both the corporate and personal levels.[31] Nevertheless, the relatively low AMT rate and the $40,000 exemption help to reduce the likelihood of double taxation of dividends.

Indeed, under the current system the inclusion of dividends without any other preferences would not trigger AMT. This is because even with the favourable treatment given to dividends under the regular tax system, the top marginal rate on dividends is 19.6 per cent, which exceeds the 17-per-cent rate under the AMT. This is shown in Example 2a. However, if the individual has AMT preference items, there is a potential for dividends to be exposed to AMT, as indicated in Example 2b.

Under the AMT capital gains are fully taxable. As with dividends, the inclusion of the non-taxed portion of capital gains in taxable income will not by itself cause a taxpayer to pay AMT. Again, this is because of the difference between the top federal rate of 29 per cent and the AMT rate of 17 per cent in addition to the $40,000 exclusion (see Example 3a). In this case, the top marginal rate (ignoring surtaxes) is 21.75 per cent (¾×29 per cent) under the regular tax system compared to 17 per cent for the AMT. However, if there are other AMT preferences, then the inclusion of the non-taxed portion of capital gains can help to trigger the AMT.

[31] Note that since the dividend tax credit can be claimed for dividends received from profits on which little or no corporate tax was paid, the minimum tax could help to rectify this problem. The Technical Committee on Business Taxation examined this issue and proposed a corporate distribution tax, which is similar to taxes used in Europe, to address this problem directly. See the discussion on integration in Chapter 7 of the *Report of the Technical Committee on Business Taxation* (Ottawa: December 1997).

**EXAMPLE 2 – Dividends and the AMT**

| | Regular Tax ($) | AMT ($) |
|---|---|---|
| ***a) Individual has $100,000 in dividends with no other deductions*** | | |
| Taxable Dividend | 125,000 | 100,000 |
| Taxable Income | 125,000 | 100,000 |
| AMT Exemption | | 40,000 |
| Net Taxable Income | 125,000 | 60,000 |
| Tax on Income | 31,812 | 10,200 |
| Dividend Tax Credit | 16,663 | |
| Net Tax on Income | 15,149 | 10,200 |
| ***b) Individual has $100,000 in dividends with $50,000 deduction for carrying charges*** | | |
| Taxable Dividend | 125,000 | 100,000 |
| Carrying Charges | 50,000 | – |
| Taxable Income | 75,000 | 100,000 |
| AMT Exemption | | 40,000 |
| Net Taxable Income | 75,000 | 60,000 |
| Tax on Income | 17,312 | 10,200 |
| Dividend Tax Credit | 16,663 | |
| Net Tax on Income | 649 | 10,200 |

**EXAMPLE 3 – Capital Gains and the AMT**

| | Regular Tax ($) | AMT ($) |
|---|---|---|
| ***a) Individual has $500,000 capital gain with no other deductions*** | | |
| Capital Gain | 500,000 | 500,000 |
| Taxable Gain | 375,000 | 500,000 |
| Taxable Income | 375,000 | 500,000 |
| AMT Exemption | | 40,000 |
| Net Taxable Income | 375,000 | 460,000 |
| Tax on Income | 104,312 | 78,200 |
| ***b) Individual has $500,000 capital gain eligible for capital gains exemption and no other income*** | | |
| Capital Gain | 500,000 | 500,000 |
| Taxable Gain | 375,000 | 500,000 |
| Cap. Gain Exemption | 375,000 | 375,000 |
| Taxable Income | – | 125,500 |
| AMT Exemption | – | 40,000 |
| Net Taxable Income | – | 85,000 |
| Tax on Income | – | 14,450 |
| ***c) Individual has $500,000 capital gain eligible for capital gains exemption and other income*** | | |
| Capital Gain | 500,000 | 500,000 |
| Taxable Gain | 375,000 | 500,000 |
| Other Income | 157,400 | 157,400 |
| Total Income | 532,400 | 657,400 |
| Cap. Gain Exemption | 375,000 | 375,000 |
| Taxable Income | 157,400 | 282,400 |
| AMT Exemption | | 40,000 |
| Net Taxable Income | 157,400 | 242,400 |
| Tax on Income | 41,208 | 41,208 |

### *Effect of the Lifetime Capital Gains Exemption*

While capital gains by themselves will generally not trigger AMT, the use of the $500,000 lifetime capital gains exemption by itself will cause a tax filer to pay minimum tax when the tax filer has no other income and the capital gain is greater than $160,000. This situation is shown in Example 3b. The reason is that while the exemption reduces taxable capital gains to zero under the regular tax system, under the AMT, 25 per cent of the capital gain is added to taxable income (see the section entitled "The AMT in Practice" above). On the other hand, if an individual has substantial amounts of other income and no other AMT preferences, he or she may not be subject to minimum tax. For example, for a $500,000 capital gain, if the individual has more than $157,400 in other income, then regular tax payable will exceed AMT payable (see Example 3c).

### *Reasons for Individuals Having to Pay the AMT*

This section addresses the question of why individuals pay minimum tax rather than regular tax. To determine the relative importance of a preference included in the AMT base, the Personal Income Tax T1 Model was used to recalculate the amount of AMT individuals would have to pay if one of the tax preferences was taken out of the AMT base. This exercise was conducted for RRSP deductions (up to 1994), the inclusion of capital gains, CCA losses, resource expenditure losses, carrying charges, employee stock option deductions and deductions for home relocation loans. The model was also used to determine what would happen if the dividend gross-up and credit system was used with the AMT. Table 4-2 presents the percentage of filers affected and the percentage reduction in the amount of AMT paid when a change is made to the AMT base using 1997 data. In effect, Table 4-2 indicates what would happen if a preference was allowed under the AMT rather than disallowed. Because AMT may be triggered by a combination of preferences, the removal of any one of them may cause the individual to pay regular rather than minimum tax (i.e., a 100-per-cent reduction in AMT for that individual), even though it is only a portion of total preferences. Therefore, the contribution of the various preferences should not be added together.

In 1997, 62 per cent of total AMT filers would have been affected if capital gains had been removed from the base, leading to a 42-per-cent drop in total AMT revenue. In general, the inclusion of the normally exempt one-quarter of capital gains was the most important contributor to AMT revenues. In 1994, capital gains were responsible for 86 per cent of AMT revenue. This reflects the increase in capital gains realized in 1994 due to the termination of the general lifetime capital gains exemption.[32]

Losses due to carrying charges on resource expenditures or rental and leasing property were added to the AMT base in 1995, and have become the second most important component in the AMT base. If these carrying charges had not been included in the base, AMT revenue would have been 31 per cent lower in 1997.

[32] Results for previous years are presented in Appendix 1.

Table 4-2
**Percentage of AMT Filers Affected and the Percentage Reduction in AMT Revenue Caused by a Change in the AMT Base, 1997**

| | Excluded Capital Gains (%) | | Losses From Carrying Charges (%) | | Treatment of Dividends (%) | |
|---|---|---|---|---|---|---|
| Gross Income ($) | Filers | Amount | Filers | Amount | Filers | Amount |
| 25,000 – 50,000 | 4.1 | 0.8 | 0.0 | 0.0 | 100.0 | 89.1 |
| 50,000 – 100,000 | 18.2 | 1.1 | 21.6 | 21.6 | 54.3 | 25.8 |
| 100,000 – 250,000 | 65.4 | 26.9 | 26.3 | 48.0 | 60.9 | 28.2 |
| 250,000 and Over | 79.3 | 47.7 | 18.9 | 28.4 | 61.1 | 29.1 |
| Total | 62.0 | 42.1 | 21.3 | 30.6 | 60.6 | 29.0 |

| | Losses From Resource Property (%) | | Losses From CCA (%) | | Employee Stock Options (%) | |
|---|---|---|---|---|---|---|
| Gross Income ($) | Filers | Amount | Filers | Amount | Filers | Amount |
| 25,000 – 50,000 | 0.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 50,000 – 100,000 | 1.3 | 0.7 | 8.6 | 21.6 | 0.0 | 0.0 |
| 100,000 – 250,000 | 16.3 | 14.0 | 1.4 | 0.1 | 1.4 | 1.0 |
| 250,000 and Over | 12.0 | 10.8 | 1.4 | 2.0 | 2.9 | 2.4 |
| Total | 11.1 | 10.7 | 2.7 | 2.8 | 1.8 | 2.1 |

If dividends were treated as they are under the regular tax system, AMT revenues would also be lower. In 1997, the drop would have been 29 per cent. On average, between 1988 and 1997 revenues would have been reduced by 20 per cent if the gross-up and credit system had been used.

Losses from resource property are the next most important component, accounting for 11 per cent of revenue in 1997 (down from 15 per cent in 1996). Losses from CCA and the employee stock option deduction each contribute between 2 and 3 per cent of revenue, while the home relocation loan deduction and the disallowed non-refundable credits and other credits had little effect on AMT revenues.

The RRSP deduction was a relatively insignificant factor in the AMT base except in 1993, when it accounted for 31 per cent of gross AMT revenue. It was this sharp rise that prompted the 1998 budget measure to remove RRSPs from the AMT base.

Table 4-2 also presents the results broken down by gross income. For instance, if capital gains were removed from the base, only 4.1 per cent of filers in the $25,000 to $50,000 income group would have had their AMT reduced or eliminated (paying regular tax instead), leading to a 0.78-per-cent drop in the amount of minimum tax paid by that income group. In general, most of these preferences are used by high-income individuals, particularly the employee stock option deduction. However, the treatment of dividends was an important factor for individuals in the $25,000 to $50,000 income group. In fact, all filers in this group were affected and AMT revenue would have been 89 per cent lower if the dividend gross-up and credit was used. (The revenue decline

is not 100 per cent since some filers still had to pay AMT due to the amount of their preferences). In addition, losses from CCA were relatively more important for filers with gross incomes between $50,000 and $100,000.

A related issue concerns the change in the number of AMT filers who had no regular tax payable. In particular, how does the removal of a preference affect the number of otherwise non-taxable filers who have to pay AMT? Table 4-3 indicates the percentage reduction in otherwise non-taxable filers who pay AMT when a preference is removed. The removal of capital gains from the AMT base would have the largest impact, while losses from carrying charges and the treatment of dividends also have a significant effect. Most of the reductions were for individuals with high gross incomes. Losses from CCA, the deduction for home relocation loans and the disallowance of certain non-refundable credits had no effect on the number of otherwise non-taxable filers caught by the AMT.

Table 4-3
**Number of Otherwise Non-Taxable Filers Who Pay AMT When a Preference Is Removed, 1997**

| | # of Filers | % Change |
|---|---|---|
| Before Changes | 1083 | |
| Excluded Capital Gains | 498 | 54 |
| Losses From Carrying Charges | 891 | 18 |
| Treatment of Dividends | 904 | 17 |
| Losses From Resource Property | 1021 | 6 |
| Employee Stock Options | 1070 | 1 |

## Why Do Some High-Income Individuals Pay No Taxes Even With the AMT?

While the AMT has reduced the number of high-income filers who pay no taxes, there still remain a significant number of individuals who pay no taxes even with the AMT. This is because the AMT still allows several deductions that, when used by themselves or with other deductions, can allow a high-income individual to reduce his or her taxes to zero.

Even with the AMT, it is difficult to determine exactly why individuals were able to pay no income tax at an aggregate level. This is because, at the individual level, high-income non-taxpaying filers will generally claim a combination of preferences rather than one large deduction. Nevertheless, one can use the aggregate data to get a general sense of the relative importance of various preferences.

In 1997, 24 per cent of the non-taxpaying filers who had a total income for tax purposes of more than $100,000 had zero taxable income, meaning these filers used deductions such as RRSPs, business losses and carrying charges to reduce their taxes to zero. Of the remaining 76 per cent of filers who had positive taxable incomes, over half (57.8 per cent) had taxable incomes of more than $100,000. This suggests that

preferences such as the dividend tax credit, the foreign tax credit and charitable contributions, which are claimed after gross regular taxes are determined, were important factors in reducing taxes to zero for many filers.

Table 4-4 presents a list of preferences for individuals with total incomes for tax purposes of more than $100,000 who paid no taxes. Note that some of these preferences are included in the AMT base.[33] Since it usually requires more than one preference to trigger AMT, it is possible for some disallowed preferences to contribute towards reducing taxes to zero despite the AMT. The table indicates the percentage of these filers who used a given preference, the average deduction claimed, and the percentage of the total value of deductions claimed for each preference. Note that these percentages can vary widely from year to year.

From the table, the two most important preferences that allowed many high-income individuals to reduce their taxes to zero, the foreign tax credit and the lifetime capital gains exemption, are not included in the AMT base. The foreign tax credit accounted for 24 per cent of the total deductions of all high-income non-taxable filers and was used by 32 per cent of high-income non-taxable filers.

The lifetime capital gains exemption for farm and small business property is also prominent among these filers, accounting for 22 per cent of total deductions. It was used by 24 per cent of high-income non-taxable filers.

The next preference in Table 4-4 is labelled "Additional Deductions From Net Income," which is how it appears on a tax return and therefore in the data. Deductions for vows of perpetual poverty (where income is earned and given to a religious order), for net employment income from an international organization, and for foreign income received under a tax treaty are included in this item.

Relatively few filers claim allowable business investment losses (3.6 per cent), but the average deduction is very large (nearly $356,000). The same is also true for non-capital losses carried over from previous years.[34] For this reason, these two deductions are fourth and fifth respectively in Table 4-4. The deduction for capital losses of previous years is not as significant, but the average deduction is relatively high.

---

[33] A complete list of preferences indicating those that are included in the AMT base is shown in Appendix 2.

[34] Some of these non-capital losses may be allowable business investment losses carried over from previous years.

Table 4-4

**Preferences Which Allowed Individuals With Incomes Over $100,000 to Reduce Their Taxes to Zero in 1997**

| Deduction or Credit | % of High-Income, Non-Taxpaying Filers | Average Deduction ($) | % of Total Deductions |
|---|---|---|---|
| Foreign Tax Credit[1] | 32.3 | 111,245 | 24.11 |
| Lifetime Capital Gains Exemption | 24.3 | 137,046 | 22.41 |
| Additional Deductions From Net Income[2] | 14.4 | 174,747 | 16.86 |
| Allowable Business Investment Losses | 3.6 | 355,899 | 8.61 |
| Non-Capital Losses of Other Years | 6.7 | 167,975 | 7.56 |
| Carrying Charges and Interest Expenses | 27.7 | 33,304 | 6.19 |
| Other Deductions From Net Income[3] | 15.0 | 44,544 | 4.49 |
| Charitable Contributions[4] | 25.2 | 26,427 | 4.48 |
| RRSP/RPP Contributions | 40.6 | 11,481 | 3.13 |
| Capital Losses of Other Years | 5.1 | 77,118 | 2.62 |
| Dividend Tax Credit[1] | 17.1 | 12,666 | 1.45 |
| Employment Expenses | 3.4 | 19,738 | 0.45 |
| Employee Stock Options | 0.4 | 81,154 | 0.23 |
| Alimony/Support Payments | 1.5 | 22,522 | 0.23 |
| Exploration and Development Expenses | 1.2 | 9,278 | 0.07 |
| Overseas Employment Tax Credit[1] | small | 73,563 | 0.05 |
| Minimum Tax Carry-Forward[1] | 1.1 | 4,894 | 0.03 |
| Investment Tax Credit[1] | 1.2 | 3,153 | 0.02 |
| Labour-Sponsored Funds Tax Credit[1] | 1.1 | 1,826 | 0.01 |

[1] Converted to a deduction equivalent assuming a 29% tax rate.

[2] Includes any deduction for foreign income received under a tax treaty, for a vow of perpetual poverty or for employment for a prescribed international organization.

[3] Included deductions for Canadian motion picture, film and video tapes and other miscellaneous deductions.

[4] Amount of charitable contributions assumed to be equivalent to a deduction.

It is important to keep in mind that the amount of losses claimed varies widely from year to year.[35] For instance, while the deduction for limited partnership losses from previous years was not used in 1997, it was used by some filers in 1996.

Many high-income, non-taxpaying filers also had significant deductions for carrying charges. Two common tax credits include the credit for charitable contributions and the dividend tax credit. RRSP contributions may be the most popular preference in the list (it was used by 40.6 per cent of high-income non-taxable filers), but since the deduction is limited to $13,500, it is not a key preference for reducing taxes to zero.

[35] As an example of how widely the use of these preferences fluctuates, 20 per cent of high-income non-taxpaying filers had non-capital losses from previous years in 1996, but only 6.7% did in 1997.

This is indicated by the fact that RRSPs constitute only a little over 3 per cent of the total deductions and credits claimed. The remaining preferences are fairly insignificant, at least for the 1997 tax year. Nevertheless, the size of the average deduction indicates those that are more important to specific filers. The overseas employment tax credit and the deduction for employee stock options are notable examples.

## V. Overall Assessment

The AMT was meant to "prevent high-income individuals from using one or more tax incentives to pay little or no tax in any given year."[36] However, it was also important that "existing tax incentives put in place for valid economic and social reasons [not be] undermined by the minimum tax."[37] Therefore, it was important for the AMT to strike an appropriate balance between these two objectives.

When the AMT was introduced, it was observed that "very few high-income individuals [had] been able to avoid paying taxes for any number of years."[38] Therefore, even though the overall scope of the problem was small, the Government still felt that it needed to be addressed.

In addition, it was noted that the allowance of some deductions and tax credits would mean that some high-income Canadians would still pay no tax in a given year "in a strictly limited range of situations."[39]

Has the AMT satisfied its objectives? The proportion of high-income, non-taxable returns has fallen by an average of 65 per cent since the AMT was implemented. While a significant portion of this drop may be due to other changes in the tax system, the immediate drop in the percentage of non-taxable filers in 1986 suggests that the AMT had a substantial impact, either directly by causing individuals with no regular tax to pay some tax, or indirectly by causing individuals to alter their behaviour. While its overall revenue impact has been small, this is not out of line given the size of the problem the AMT was meant to address. In addition, since most of the individuals who pay the AMT were already paying regular tax, it can be concluded that the AMT ensured that many other individuals paid their fair share of tax.

Nevertheless, a number of high-income individuals are still able to reduce their tax liability to zero even with the AMT (this was recognized at the outset by the Government before it implemented the AMT). Two significant preferences used by these filers are the foreign tax credit and the lifetime capital gains exemption.

---

[36] Department of Finance Canada, "Minister Announces Minimum Tax."

[37] Ibid.

[38] Ibid.

[39] Ibid.

Another issue concerning the AMT is the cost of compliance. Filers have to fill out a complicated form and essentially recalculate their taxes using the AMT base. After numerous calculations, some filers may determine that they do not have to pay minimum tax after all. In addition, the carry-over provision requires extra bookkeeping by both the Government and the taxpayer. Despite this, since most of the information required for the AMT is already provided under the regular tax system, the compliance burden is likely small.

Therefore, it can be concluded that the AMT has contributed to the reduction in the proportion of high-income non-taxable returns at a relatively minor cost to the public. In addition, the structure of the tax does not undermine the policy objectives behind the various preferences and reinforces tax fairness.

# APPENDIX 1: Data Tables

Table A1.1
**Income Distribution of AMT Filers, by Gross Income, 1988 – 1997**

| | 1988 | | 1989 | | 1990 | | 1991 | | 1992 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Gross Income ($) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) |
| Negative or Nil | 6.2 | 18.9 | 0.0 | 0.0 | 0.7 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| 0 – 25,000 | 2.1 | 0.7 | 0.7 | 1.2 | 3.7 | 2.5 | 5.3 | 2.9 | 0.9 | 0.4 |
| 25 – 50,000 | 10.1 | 4.1 | 4.0 | 1.6 | 22.6 | 11.8 | 24.7 | 11.6 | 12.5 | 6.4 |
| 50,000 – 100,000 | 21.0 | 7.4 | 19.4 | 8.3 | 21.3 | 8.7 | 26.7 | 16.7 | 24.3 | 12.2 |
| 100,000 – 250,000 | 33.8 | 22.6 | 41.5 | 18.9 | 22.6 | 13.4 | 20.8 | 11.6 | 27.2 | 12.4 |
| 250,000 – Over | 26.9 | 46.4 | 34.4 | 69.9 | 29.1 | 63.5 | 22.8 | 57.2 | 35.1 | 68.5 |

| | 1993 | | 1994 | | 1995 | | 1996 | | 1997 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Gross Income ($) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) |
| Negative or Nil | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.01 | 0.02 | 0.00 | 0.00 |
| 0 – 25,000 | 1.4 | 0.5 | 0.0 | 0.0 | 2.4 | 10. | 0.00 | 0.0 | 0.00 | 0.0 |
| 25 – 50,000 | 13.7 | 6.1 | 0.0 | 0.0 | 18.4 | 8.2 | 2.9 | 0.6 | 2.0 | 0.4 |
| 50,000 – 100,000 | 23.3 | 11.4 | 5.8 | 1.8 | 31.7 | 13.4 | 16.0 | 4.5 | 18.6 | 5.6 |
| 100,000 – 250,000 | 26.7 | 13.0 | 30.8 | 9.0 | 25.3 | 17.4 | 26.2 | 20.3 | 31.3 | 13.5 |
| 250,000 – Over | 35.0 | 69.0 | 63.3 | 89.1 | 22.2 | 59.9 | 44.9 | 74.7 | 48.1 | 80.6 |

Table A1.2
**Average Amount of Minimum Tax Paid, by Income Group, 1988 – 1997**

| Gross Income ($) | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | ($) | | | | | |
| Negative or Nil | 20,183 | 16,000 | 878 | 12,000 | 6,400 | 9,800 | 12,333 | 18,333 | 1,000 | – |
| 0 – 25,000 | 2,335 | 10,310 | 2,318 | 2,131 | 1,745 | 1,429 | 3,000 | 1,821 | – | – |
| 25 – 50,000 | 2,679 | 2,235 | 1,817 | 1,819 | 1,964 | 1,865 | 9,000 | 1,871 | 1,189 | 1,189 |
| 50,000 – 100,000 | 2,335 | 2,448 | 1,424 | 2,460 | 1,921 | 2,040 | 1,512 | 1,767 | 1,659 | 1,936 |
| 100,000 – 250,000 | 4,445 | 2,595 | 2,034 | 2,164 | 1,740 | 2,034 | 1,460 | 2,876 | 3,307 | 2,790 |
| 250,000 – Over | 11,460 | 11,549 | 7,580 | 9,758 | 7,465 | 8,229 | 6,989 | 11,283 | 9,836 | 10,851 |
| All Filers | 6,643 | 5,686 | 3,480 | 3,888 | 3,821 | 4,172 | 4,968 | 41,841 | 5,911 | 6,474 |

Table A1.3

**Percentage of AMT Filers Affected and the Percentage Reduction in AMT Revenue Caused by a Change in the AMT Base, 1988 – 1997**

| | 1988 | | 1989 | | 1990 | | 1991 | | 1992 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Preferences | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) |
| Excluded Capital Gains | 62.3 | 39.9 | 79.4 | 77.9 | 49.6 | 50.7 | 43.1 | 38.3 | 54.2 | 61.1 |
| Losses From Carrying Charges | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Losses From CCA | 7.9 | 4.6 | 3.5 | 2.5 | 5.0 | 4.1 | 4.9 | 2.5 | 10.9 | 5.0 |
| Losses From Resource Property | 17.7 | 10.2 | 5.7 | 4.0 | 3.8 | 4.8 | 1.5 | 16.0 | 3.2 | 3.9 |
| Employee Stock Options | 0.3 | 0.2 | 0.7 | 0.7 | 0.4 | 0.9 | 0.1 | 0.3 | 0.3 | 0.2 |
| RRSPs | 6.0 | 2.6 | 4.0 | 4.5 | 2.9 | 2.8 | 2.4 | 2.0 | 9.0 | 4.3 |
| Treatment of Dividends | 57.5 | 14.1 | 48.4 | 14.0 | 46.6 | 26.7 | 43.0 | 18.8 | 43.1 | 22.4 |

| | 1993 | | 1994 | | 1995 | | 1996 | | 1997 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Preferences | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) | % of Filers | Amount (%) |
| Excluded Capital Gains | 62.4 | 68.2 | 91.8 | 86.0 | 67.5 | 44.7 | 63.9 | 41.9 | 62.0 | 42.1 |
| Losses From Carrying Charges | n.a. | n.a. | n.a. | n.a. | 18.7 | 34.5 | 22.3 | 32.9 | 21.3 | 30.6 |
| Losses From CCA | 2.5 | 2.3 | 1.6 | 3.9 | 3.3 | 7.4 | 0.6 | 1.4 | 2.7 | 2.8 |
| Losses From Resource Property | 3.9 | 4.1 | 5.9 | 5.3 | 7.2 | 7.5 | 11.2 | 14.5 | 11.1 | 10.7 |
| Employee Stock Options | 0.6 | 0.6 | 3.3 | 1.8 | 1.3 | 2.5 | 2.5 | 3.0 | 1.8 | 2.1 |
| RRSPs | 75.0 | 31.3 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Treatment of Dividends | 45.7 | 15.7 | 50.0 | 18.4 | 56.9 | 20.5 | 52.5 | 24.4 | 28.5 | 29.0 |

# APPENDIX 2: List of Tax Preferences and Deductions

| Tax Preferences | Included in AMT Base? | Remarks |
|---|---|---|
| ***Before Total Income:*** | | |
| Losses due to CCA and carrying charges on rental and leasing property | **Yes** | This tax shelter has been closed since 1994. |
| Losses due to CCA and carrying charges on certified film property | **Yes** | This tax shelter has been closed since 1995. |
| Losses from limited partnerships or tax-shelter partnerships | **Yes** | Some of these deductions were related to those above. |
| Deductible amounts with respect to tax shelters | **Yes** | |
| Carrying charges related to limited partnership, or partnership that owns rental, leasing or film property | **Yes** | |
| Non-taxable portion of capital gains | **Yes** | Does not include non-taxable portion of gains resulting from foreclosures, conditional sales repossessions, gains exempt under a tax treaty, and gains on certain gifts and donations. |
| Exemption of first $500 of scholarship income | No | |
| Other exempt income (e.g., capital dividends) | No | |
| ***Before Net Income:*** | | |
| RPPs and RRSPs | No | Effective 1994 tax year. |
| RESPs | No | |
| Union dues | No | |
| Child care expenses | No | |
| Attendant care expenses | No | |
| Allowable business investment loss | No | 100% deductible rather than 75% deductible. |
| Moving expenses | No | |
| Support payments | No | |
| Carrying charges and interest expenses | **Yes** | Only for investments relating to tax shelters, limited partnerships, resource property, certified film property or rental and leasing property. |
| Exploration and development expenses | **Yes** | Only to the extent that carrying charges and depletion allowances and other expenditures create a loss. |
| Interest and dividend income deduction | **Yes** | Deduction withdrawn in 1988 tax year. |
| Other employment expenses | No | |
| Meals and entertainment expenses | No | |
| Other deductions (*see list below) | No | |

| Tax Preferences | Included in AMT Base? | Remarks |
|---|---|---|
| ***Before Taxable Income:*** | | |
| Employee home relocation loans | **Yes** | |
| Stock option and shares deduction | **Yes** | |
| Limited partnership losses of other years | **Yes** | Only losses from CCA and carrying charges on Multiple-unit residential buildings, film property, rental and leasing property, and resource expenditures and depletion allowances. |
| Non-capital losses of other years | **Yes** | See above. |
| Net capital losses of other years | No | Net non-deducted losses from previous years are subtracted from the AMT base. |
| Lifetime capital gains deduction | No | |
| Northern residents deduction | No | |
| Additional deductions | No | |
| ***Non-Refundable Credits:*** | | |
| Personal non-refundable credits | No | |
| CPP/EI contributions | No | |
| Pension income | **Yes** | |
| Caregiver amount | No | |
| Disability amount | No | |
| Disability amount transferred from dependant other than spouse | **Yes** | |
| Interest on student loans | No | |
| Tuition and education amounts | No | |
| Tuition and education transferred from child | **Yes** | |
| Amounts transferred from spouse | **Yes** | |
| Medical expenses | No | |
| Charitable contributions credit | No | |
| ***Other Credits:*** | | |
| Dividend tax credit | **Yes** | Dividends are included at their cash value. |
| Foreign tax credit | No | Modified version is used for AMT purposes. |
| Logging tax credit | **Yes** | |
| Overseas tax credit | **Yes** | |
| Political contribution tax credit | **Yes** | |
| Labour-sponsored funds credit | **Yes** | |
| Investment tax credit | **Yes** | Non-refundable portion only. |

* Other deductions include assistance for artists and musicians, and deductions for clergy and those who have taken vows of perpetual poverty.

# GST/HST Treatment of Export Distribution

# I. INTRODUCTION

The 2000 budget announced changes to the goods and services tax/harmonized sales tax (GST/HST) treatment of export distribution activity. This paper provides detailed information on these changes. The proposed changes would ensure that the cash-flow implications from having to pay and finance the GST/HST do not impose unintended costs that would preclude Canada as a location for North American distribution businesses. The measures would enable participants to acquire or import most goods without the payment of GST/HST where those businesses export substantially all of their outputs or perform export distribution operations for other businesses, and add limited value added in the course of processing goods.

The legislative proposals for these changes would come into force on January 1, 2001, so as to allow for consultations in the spring of 2000.

# II. BACKGROUND

## The GST/HST Treatment of Export Distribution Activity

A number of programs under the GST/HST provide cash-flow relief with respect to the export sector. These programs are each targeted towards a certain type of export-oriented activity. However, as a result of ongoing monitoring of the GST/HST application to the import and export sectors, it was determined that none of the programs adequately deal with the problem faced by businesses involved in distribution activities. These export-oriented firms want to perform some limited processing activity on goods either imported or purchased in Canada for export. An increasing number of firms are engaged in this type of activity, such as the installation of software or customization of products to reflect purchasers' specific needs.

No GST/HST applies to exported goods and services, and tax paid by exporters on their inputs is fully refundable though the input tax credit mechanism. However, in cases where there is minimal processing in Canada, the cost of financing the GST/HST paid on either imported or domestically acquired goods to be processed, as well as various component parts, can be significant in relation to the level of value added to goods. In particular, these financing charges can be significant given that the profit margins of these types of businesses are low in relation to the value of goods processed. Thus, for these types of businesses, financing the GST/HST component can increase their capital requirements, ultimately affecting the viability of locating such an operation in Canada.

## How the GST/HST Operates

The GST/HST is a tax on the final consumption of goods and services in Canada. A supplier is required to collect either the GST at the rate of 7 per cent or the HST at a rate of 15 per cent on any taxable supplies, other than "zero-rated" supplies[1], made in Canada. In order to eliminate the taxation of inputs, the GST/HST is designed as a multi-stage tax.

[1] Zero-rated goods and services are those to which a "zero" rate of tax applies – in other words, they are totally tax-free.

While businesses throughout the production and distribution chain charge tax on their domestic sales, they are able to claim a refundable credit, called an "input tax credit", for any tax paid on purchases of goods and services used in the course of carrying on business.

Based on a determined reporting schedule, a business simply adds up all of the GST/HST it has paid to suppliers, and subtracts this from the GST/HST it collects on it sales. Only the net amount – tax collected less tax paid – is remitted to the Government.

Under the GST/HST system, businesses that supply the domestic market are generally required to collect the GST/HST on their supplies. Where the GST/HST is collected, the vendor may receive a cash-flow benefit from holding the GST/HST amounts in trust until they are required to be remitted to the Government. For most businesses, the amounts collected would be greater than the GST/HST paid on purchases.

A key objective of a value-added tax such as the GST/HST is to fully relieve exported goods and services from the tax. Thus, no GST/HST is charged on sales made outside of Canada and goods and services destined for export are zero-rated. Under the GST/HST system, where an exporter purchases or imports goods, it must pay tax on the purchases, which it subsequently recovers through the input tax credit mechanism. Where the Government has not sent the refund of GST/HST within 21 days of receiving the GST/HST return, it pays interest based on the amount owed calculated by reference to recent Treasury Bill rates.

Exporters face a cash-flow burden because they do not collect any GST/HST to offset the amount of the GST/HST they pay on their purchases, but rather claim the tax back through the input tax credit mechanism. However, it is important to recognize that alternative approaches to this mechanism to relieve this burden and to ensure that sales tax applies only at the point of final consumption in Canada, such as single-stage sales taxes (e.g., retail sales tax), involve the universal use of exemption certificates. These certificates provide point-of-sale tax relief in limited circumstances. That is, not all businesses are able to use the certificates and the certificate cannot be used for all purchases. Indeed, as a general rule, about a third of revenues from such taxes come from taxes on business inputs. As a result, tax systems that rely on exemption certificates cannot remove all of the tax from exports.

In addition, since a good may have several different uses, vendors and tax authorities find it difficult to determine whether the sale is tax-free or not. The liberal use of certificates would cause significant exceptions to the general application of the sales tax. For tax administrators, a system using exemption certificates, unlike an input tax credit system, provides few opportunities for cross-verification.

The GST/HST, on the other hand, allows purchasers to claim input tax credits and, therefore, eliminates tax cascading and administrative complexities. However, the benefits may come, in special circumstances, at the cost of a cash-flow burden for certain sectors, such as exporters.

## III. Proposed Changes to the GST/HST Treatment of Export Distribution Activity

To address the issues discussed above relating to export distribution activities, changes to the GST/HST treatment of these activities are proposed. The changes would ensure that the cash-flow implications from having to pay and finance the GST/HST do not impose costs that would preclude Canada as a location for North American distribution businesses. The measures would be designed in a targeted manner to ensure that the effectiveness of the multi-stage GST/HST tax is not impaired.

### Overview

The changes are aimed at export distribution businesses that perform limited processing on goods before they are exported. These proposals do not require the establishment of specific geographic "tax-free zones" or "foreign trade zones." Nonetheless, the changes, when coupled with other existing programs (e.g., the Duty Deferral Program that provides duty relief), would provide the benefits of such zones. But unlike tax-free zones or foreign-trade zones, which restrict the benefits only to those businesses situated within a particular geographical area, the changes would apply to eligible businesses regardless of where they are located. As such, this approach would not promote the dislocation of existing industry from one locale to another, which could be the case if designated geographical zones were created.

The proposed changes are aimed only at those export-oriented businesses that carry on limited processing where the cash-flow costs associated with the GST/HST are significant relative to the value added. The new measures would not apply to businesses that manufacture or produce goods, thereby adding significant value in the process. In such circumstances, the cash-flow costs resulting from the GST/HST on the goods either acquired domestically or imported are much less significant in relative terms.[2]

**Example 1:** A good costs $100 to produce and bring to market. The cost (excluding soft costs) to produce the good up to the point of distribution is $50 worth of material and $35 labour. The distribution of the product (e.g., packing and shipping) costs $15. A manufacturer would be required to pay and finance $3.50 GST on material costs in the course of producing the good up to the point of distribution. In contrast, a distribution business that acquires the good or imports it on the manufacturer's behalf would be required to pay and finance $5.95 based on the value of the material and labour costs up to the point of distribution (i.e., $85).

[2] For businesses that are engaged in manufacturing and/or producing, programs such as the Duty Deferral Program and the Exporters of Processing Services Program may provide relief from any applicable duty and the GST/HST on imported goods provided the particular program conditions are satisfied.

Through the use of a certificate, a business will be able to import, tax-free, its own goods or those belonging to another person. It will also be able to purchase domestic goods tax-free by using a certificate. Tax relief would be available for the purchase of goods that are to be processed as well as goods (e.g., component parts) that are to be added or utilized in the course of the processing activity.

Tax relief would not be available in respect of imports or purchases of capital property. Also, the certificate would not be available for domestic transactions valued at less than $1,000. Limiting the use of the certificate to transactions of at least $1,000 would reduce administrative complexities for domestic vendors and would normally only involve vendors having a significant business relationship with the certificate holder.[3] Also, export distribution businesses would continue to pay GST/HST on any soft costs (e.g., rent, utilities, domestic transportation or professional services) acquired and consumed in Canada. However, as these businesses would be required to be registered for the purposes of the GST/HST in order to benefit from the proposed changes, they would be able to claim input tax credits for these GST/HST amounts in the normal fashion.

## Eligibility Requirements

For the purposes of the proposed changes, eligible businesses would be those:

- whose "export revenue" accounts for at least 90 per cent of their total revenue generated from activities in Canada; and
- that add only limited value to goods.

The export revenue threshold is intended to target the proposed changes at export-oriented businesses. For this reason, an export revenue test would apply such that at least 90 per cent of the total revenue generated in Canada by a business must be generated from exports. The test would only apply with respect to revenue generated in Canada, since the inclusion of revenue generated outside Canada in determining whether or not the threshold has been exceeded would inappropriately exclude some businesses.

The export revenue threshold would ensure that, to use the proposed changes, a business would only have limited sales in the domestic market and, therefore, would not enjoy a cash-flow advantage over other domestic suppliers by virtue of using their certificate to acquire or import goods tax-free. For the purposes of this test, "export revenue" would include revenue from the sale of goods to be exported as well as revenue from the provision of services in respect of other persons' goods that are to be exported.

It is also important to recognize with respect to the export revenue threshold that the cost to an export-oriented business of financing the GST/HST diminishes as domestic sales rise. This is due to the fact that the business is collecting GST/HST on their domestic sales and those amounts, which are held in trust by the business, are used to offset the GST/HST paid on either imported or domestically acquired goods.

---

[3] It is important to reiterate that there are significant potential risks associated with the widespread utilization of exemption certificates. As previously stated, this system typically results in tax being built into the cost of exports, and both vendors and tax authorities find it difficult to determine whether a sale should be tax-free or not.

As the proposed changes are intended to address situations where only limited value-added processing takes place in relation to turnover, eligible businesses would not be able to undertake the manufacturing or producing of goods. There would also be defined limits on value added. For those businesses that process their own goods before export, the limit would require that the direct labour content of the cost of the goods supplied by the business not exceed a prescribed percentage.[4] With respect to customers' goods, a test would apply to ensure that the value of the services provided in respect of those goods does not exceed a prescribed percentage of the total value of those services plus the value of the goods when imported or transferred to the business. In both instances, these prescribed percentages would be determined after consultations with stakeholders on the proposal.

Activities that can presently be undertaken in a customs bonded warehouse (CBW) would be specifically excluded from the value-added calculation. The rules with respect to the CBW Program allow a wide range of activities to be carried on, but these activities are subject to limitations. The exclusion of these activities that are presently allowed in a CBW reflect the fact that in certain situations, these activities, in and of themselves, could cause the defined limits on valued added to be exceeded easily.

**EXAMPLE 2:** Company A, a distribution business, purchases screws in bulk. The service it provides to the manufacturer is to break down the bulk screws and package them in plastic containers, five per package. At present, such activity can be undertaken in a CBW. Where such activity takes place under the proposed changes for export distribution activity, the value added by virtue of the packaging of the material would likely exceed the defined limits of value added to goods. However, activities, such as breaking bulk packages, that are presently allowed under the CBW Program are excluded from the value-added calculation.

## Adjustments

The export revenue test and the value-added test would be applied on an annual basis at the end of a business's fiscal year. Where these tests are not satisfied, or there has been improper use of the certificate, the export distribution business would be required to make adjustments to its net tax for the first reporting period of the business following that fiscal year. This would ensure that no cash-flow benefits are realized by the business from having used the certificate when comparing its situation to other domestic vendors.

[4] The cost of the goods should be ascertained in keeping with acceptable methods of cost determination used in inventory valuation.

**EXAMPLE 3:** Company B meets the eligibility criteria for using the proposed changes and is authorized by the Minister of National Revenue to use a certificate in order to obtain tax relief on domestic acquisitions and imports. However, at the end of its fiscal year, upon calculating its export revenue percentage for the year, it is determined that only 85 per cent of its total revenue was from exports. This was due to a large, one-time order from a domestic purchaser. As a result, Company B is required to make an adjustment to its net tax.

In certain circumstances, a business's authorization to use the proposed changes would be automatically revoked. This would occur immediately after their fiscal year where:

- the business manufactured or processed property during that year;
- the percentage value added in respect of a business's own property or that of a customer's for that year exceeds the prescribed percentage; or
- the business's export revenue percentage for that year is less than 80 per cent.

## Administration

An application for the authority to use a certificate under the proposed changes would be required in a prescribed form and manner. An application would have to be filed with the Minister of National Revenue, who would be required to verify the applicant's eligibility to participate in the program prior to authorization.

The authorization to use a certificate would be valid up to three years after the day on which the authorization became effective unless the authorization is revoked prior to that time.

Where the three-year time period draws to an end, a qualifying business would be required to formally renew its authorization by submitting a request in writing to the Minister of National Revenue.

In addition to the circumstances where automatic revocation occurs (see above), the Minister could revoke an authorization at any time throughout a fiscal year where:

- the business fails to comply with any condition attached to the authorization;
- it can reasonably be expected that the business would commence manufacturing or producing goods;
- it can reasonably be expected that the business would fail the export revenue or value-added tests; or
- the business requests that the authorization be revoked.

Where the authorization for a business to use a certificate is revoked, effective on a particular day, the business would not be entitled to reacquire a certificate before:

- the day that is two years after the particular day, if the authorization was revoked because the business failed to comply with the proposed conditions; or
- in any other case, the first day of the second fiscal year of the business beginning after the particular day.

### Coming Into Force Date

Budget 2000 proposed that the measures described above come into force on January 1, 2001. Consultations on specific aspects of the proposal, for example, to specified percentages for the value-added test, took place in the spring of 2000.

## IV. Conclusion

The proposed changes in the GST/HST treatment of export distribution activity would alleviate the cash-flow burden faced by operators of qualifying distribution businesses as a result of their having to finance the GST/HST. As a result, the targeted changes are designed in such a manner as to remove any unintended costs that would preclude Canada as a location for North American distribution without threatening the effectiveness of the multi-stage GST/HST.

The proposed changes, in conjunction with the other programs currently available for imports and exports, support an overall objective of the GST/HST in relieving tax from exported goods and services. Moreover, unlike tax-free zones and foreign trade zones, which restrict the benefits only to those companies situated within a particular geographical area, the benefits of the proposed changes and existing programs apply to eligible businesses regardless of where they are located in Canada.

## APPENDIX: Relevant Current GST/HST Rules for Exporters

The federal government recognizes the cash-flow burden often faced by export-oriented businesses and in the past has introduced programs to alleviate these associated financing costs. However, these programs are targeted towards certain types of activities. In particular, they do not allow for even limited processing of one's own goods prior to export – activities that typically take place in distribution businesses.

The programs that currently exist to provide GST/HST relief to exporters are briefly discussed below.

### Exporters of Processing Services Program

The Exporters of Processing Services (EOPS) Program allows the tax-free importation of goods that continue to be owned by an unrelated non-resident, for the purpose of processing the goods in Canada and then re-exporting them. The EOPS Program has been designed to ensure that Canadian service providers can compete with non-Canadian service providers in world markets.

The EOPS Program has limited application in the context of distribution-business type activity. First, the program is targeted to service providers. Consequently, it does not apply when the service provider owns the goods. Second, all of the goods on which services are performed must be exported, which precludes any supplies to the Canadian market whatsoever. Finally, the resident service provider who is authorized to participate in the EOPS Program receives tax relief only on imports, as the program is export-service oriented. This precludes Canadian goods purchased by the non-resident from being serviced on a tax-free basis.

Adapting the EOPS Program to apply to distribution-business type activity would be problematic due to the broad range of services that it covers. In particular, removing the criterion that the service provider not own the goods being processed, and providing for tax-free acquisition of domestic products, would significantly erode the general application of the multi-stage tax, leading to added complexity for many domestic suppliers, and creating administrative difficulties in controlling tax-free purchases in the domestic economy.

### Customs Bonded Warehouse

The CBW Program defers payment of taxes and duties until goods enter into the Canadian economy or are exported. Where the goods are exported, never having entered into the Canadian economy, no taxes or duties are payable. The CBW Program is effective in providing tax and duty relief where goods are transiting Canada, and no processing is required.

The program rules allow a wide range of activities to be carried on in a CBW. There are, however, limitations, namely that the goods in the warehouse should not be manipulated, altered or combined with other goods except in limited circumstances such as inspecting, labelling, storing, packaging or testing.[5]

The CBW Program could be used for certain distribution-centre type activities. However a number of issues arise. First, a business operating in a CBW can carry on only clearly defined limited processing activities with respect to goods. This does not reflect the nature of modern distribution centre activities, where goods are often customized to reflect particular markets or to meet a purchaser's specific requirements. Second, the CBW Program allows goods to leave the CBW either for export or to enter the domestic economy. Finally, a warehouse authorized under the CBW Program cannot acquire goods domestically free of tax; relief applies only to imports.

Expanding this program to distribution-business type activity would have negative implications. As this program provides tax relief only in respect of imported goods, it would create a bias towards importation versus domestically acquired goods. Further, the CBW Program is very broad in its application and can be used not only by export-oriented businesses, but also businesses supplying to the domestic market. Also, if minor processing were allowed under the CBW Program, an unfair distortion would be created against purely domestic suppliers such that they may face cash-flow costs on domestic and imported inputs that a CBW would not. In addition, domestic suppliers of inputs to businesses operating in a CBW would be disadvantaged compared to non-resident competitors, who would not be required to charge and collect the GST/HST when shipping into a CBW situated in Canada.

## Export Trading House

The Export Trading House (ETH) Program relieves GST/HST on domestic goods purchased for resale by businesses that are exporters. This program is the domestic counterpart of the CBW Program with respect to GST/HST relief. However, the goods cannot be further processed in any manner, except to the extent reasonably necessary or incidental to their transportation.

Two issues arise when applying the ETH Program to distribution-business type activity. First, in order to limit the effects of the program on the general application of the tax, no processing is permitted. As a distribution business must have the ability to customize goods in response to a particular market or to meet a purchaser's specific requirements, the ETH Program is not suitable. Second, GST/HST relief is provided only with respect to domestically-acquired goods and does not apply to taxes payable on imports.

This program is of little assistance to distribution businesses that frequently import goods on behalf of non-resident businesses, warehouse them and ultimately deliver them to the final purchaser.

---

[5] A complete list of acceptable activities can be found in section 3 of Part I of the Customs Bonded Warehouses Regulations.

## Other GST/HST Mechanisms

A number of other legislative mechanisms exist to provide GST/HST relief in the import and export areas. However, these provisions are limited in application and are designed to apply to particular types of common business practices.

The Drop Shipment Rules allow sales to non-residents of goods bound for export and of services performed on those goods to be made on a tax-free basis, provided that the goods remain in the possession of Canadian service providers before export. The Drop Shipment Rules essentially facilitate the transfer of goods owned by non-residents between Canadian processors. It does not provide the type of relief suitable for the distribution business sector.

The Non-Taxable Importations Program permits tax-free importation of goods for the purpose of repair, maintenance or overhaul. This program is not open to Canadian suppliers who also supply property (e.g., components) with the service. Additionally, the Non-Taxable Importations Program is restricted to certain types of services (e.g., it clearly excludes distribution type activity).